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BANKRUPTCY REFORM

HEARING

BEFORE THE

SUBCOMMITTEE ON COURTS

OF THE

COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

ON

NORTHERN PIPELINE CO. v. MARATHON PIPELINE CO. DECISION; CONSUMER CREDIT CODE AMENDMENTS; AGRICULTURAL PRODUCE BAILMENT AMENDMENTS; REPURCHASE AGREEMENT CODE AMENDMENTS; SHOPPING CENTER TENANCY AMENDMENTS; AND TIMESHARING AGREEMENTS AMENDMENTS

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BANKRUPTCY REFORM

MONDAY, JANUARY 24, 1983

U.S. Senate,
Subcommittee on Courts,
Committee on the Judiciary,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:40 a.m., in room SD-226, Dirksen Senate Office Building, Senator Robert Dole (chairman of the subcommittee) presiding.

Also present: Senators Howard M. Metzenbaum and Howell Heflin.

Staff present: Douglas B. Comer, chief counsel and staff director; Richard W. Velde, special counsel; Patricia A. Brown, chief clerk; and Arthur Briskman, minority counsel.

OPENING STATEMENT OF SENATOR ROBERT DOLE

Senator Dole. Let me say we are pleased to be starting this session of Congress with these hearings. We are convening today for the purpose of resuming our study of provisions of the 1978 Bankruptcy Reform Act begun in the 97th Congress.

The Bankruptcy Reform Act of 1978 was the first major revision of the bankruptcy laws of the United States since 1938, and its enactment was the culmination of an effort that extended over a number of years. The new code made numerous substantive changes in the law of bankruptcy and in the administration of debtor's estates.

Most of these new provisions have worked well and have had beneficial effects upon the bankruptcy system. However, it became clear soon after the new code went into effect that the changes wrought by the law in certain areas upset the delicate balance of equity between debtors and creditors, particularly with respect to consumer credit transactions.

This subcommittee thus turned its attention in early 1981 to an examination of the impact of the new law, and Senate bill 2000 was the result. That bill, which was titled the Bankruptcy Improvements Act of 1982, was the end product of the very thorough and comprehensive review of the strengths and weaknesses of the Reform Act which we conducted during the previous Congress.

Even as we completed the committee work upon that important piece of legislation, however, we in Congress began to realize that the deficiencies of the 1978 act went well beyond the area of consumer debtor bankruptcy procedures. The Supreme Court decision in the case of *Northern Pipeline Company* v. *Marathon Pipeline Company* gave graphic demonstration to this fact. In that case the

Supreme Court held that Congress had delegated too much jurisdictional authority to the bankruptcy courts in the 1978 act, assigning to the article I bankruptcy courts powers which have traditionally been reserved for the article III district courts.

In addition, defects in the provisions of the code governing corporate reorganizations and business bankruptcies were brought to our attention. Problems with grain elevator bankruptcies, repurchase agreements, timesharing agreements, and shopping center bankruptcies have also been the subject of our work and today, as we begin work in the new Congress, we have a substantial menu of bankruptcy reform issues that demand attention.

This hearing today will produce testimony on a variety of issues, but, of course, our primary focus will be how to best resolve the jurisdictional problems identified in the *Marathon* decision.

I, like many other Members of the Congress, was greatly disappointed by the failure of the 97th Congress to come to grips with *Marathon* and enact the needed legislation. The underlying reasons for this were many, but foremost among them was continuing controversy over the best method of restructuring the courts.

The crux of the dispute is this: Should plenary authority be given to the bankruptcy courts, or should their jurisdiction be split among other courts which have traditionally held article III powers? And if plenary jurisdiction over bankruptcy matters is to be given to the bankruptcy courts, should they be allowed to hear other, nonbankruptcy cases? How many judges are needed to perform the bankruptcy functions? These are the questions which we must resolve early in this session of the 98th Congress.

Another principal object of our hearings today will be further examination of the need for amendments to consumer debtor provisions of the Reform Act. Our starting point is S. 2000—a bill which was designed to revise sections of the code which have encouraged unnecessary filings, hindered good-faith creditors in recovering on their claims, and diminished the efficiency of the courts in resolving consumer cases.

Our witnesses today will include spokesmen from the ranks of business, consumer law interest groups, judges, academicians, and bankruptcy practitioners. To all I extend a welcome. I believe that our collective testimony will help us greatly in finding our way through the minefields of legitimately competing interests in bankruptcy reform.

Our first witness today is Mr. Jonathan Rose, Assistant Attorney General in charge of the Department of Justice Office of Legal Policy, who will present testimony on behalf of the administration regarding the proper legislative remedies to *Marathon.*

So I suggest as we hear the witnesses today that we reflect on some of the problems we have, and it would be my hope that we could complete our hearings as quickly as possible and then I am certain that the chairman of the committee, Senator Thurmond, and the ranking minority member, Senator Biden, will help us expedite markup and get this through the full committee so we can act as quickly as possible on the Senate floor.

I will ask Senator Heflin if he has comments.

STATEMENT OF SENATOR HOWELL HEFLIN

Senator **Heflin**. Today the subcommittee is considering the dilemma brought on by the Supreme Court in the case of the *Marathon and Northern Pipeline Co.* I would like to thank our chairman, Senator Dole, for conducting this hearing and for his dynamic leadership in the meaningful reform of the administration of justice.

The Supreme Court delayed its decision until December 24, 1982, to give the lameduck session of the 97th Congress an opportunity to tackle this problem. This was the second deadline.

An earlier deadline in September was previously declared. In the interim, the Judicial Conference issued a rule, that is, following the December 24, 1982, date, upon which the bankruptcy courts in each Federal court are now functioning.

The bankruptcy court structure was developed as a part of the sweeping reforms of the substantive bankruptcy law made by Congress in 1978. While I was not a Member of the Senate at that time, I am aware that years of study and debate went into the formulation of these reforms, designed to enhance judicial expediency. The core concept of the 1978 act was to give the bankruptcy courts nationwide jurisdiction and the power to decide not only claims arising upon the bankruptcy filing, but also any claim or issue involving the bankrupt.

Before then all of these related cases had to be decided in State courts or by an article III Federal judge. It is this broad grant of judicial power that the Supreme Court says is constitutionally flawed. That decision in my judgment was flawed because it was not decided under the constitutional concept of federalism.

Our response to the Court-declared defect is especially significant in light of the *Manville* case, which has raised complex questions about the purpose of the Bankruptcy Act and the role of the bankruptcy court.

As my colleagues know, the Johns-Manville Corp. and several other major companies have asked for relief and protection under the Bankruptcy Act. Even though Johns-Manville is currently solvent, it is faced with tens of thousands of lawsuits seeking damages for asbestos-related injuries.

Under the 1978 act the bankruptcy court can hear any case—and I say any case—arising anywhere in the country that is related to the Manville petition. Bankruptcy judges also can hear any civil action, whether it be labor-management, product liability, civil rights, or even a divorce case, if they are related to the claims of a petitioner.

For example, with the courts' nationwide jurisdiction, if any individual is a defendant in a product liability case in Alaska, a land dispute case in Maine, and files a petition in bankruptcy in Alabama, the bankruptcy court in Alabama would have all the parties in Alaska and Maine come to Alabama to have their rights adjudicated.

Frankly, this all-encompassing jurisdiction troubles this Senator. Forum shopping may develop as a race that makes the Kentucky Derby seem slow.

I want to point out that the potential insolvency under this could be a cause for petitions in involuntary bankruptcy as well as in voluntary bankruptcy.

If potential insolvency is a test rather than existing insolvency, then hold onto your seats for the two-judge district of a district within a State may well turn out to be the forum in which there is the most litigation in the United States.

Ever since the Northern Pipeline dilemma arose several good-faith proposals have been offered as a solution. The most widely discussed concept is a variety of proposals upgrading bankruptcy judges to article III status, but to merge with an existing district court or a separate court.

In this hearing today we will examine the merits of these various proposals and explore whether we need to rethink the existing premise of expanded jurisdiction in the 1978 act and exactly what role we want the bankruptcy court to play.

Whatever solution we develop, two considerations must be paramount: judicial economy and efficiency, and constitutionality.

Congress must now face its constitutional obligation and prepare to fashion its response to this situation.

Today the subcommittee will also examine several proposed substantive reforms in the bankruptcy law. The 1978 Bankruptcy Reform Act represented a liberalization of substantive law of bankruptcy. It has become clear, however, that not only based on the new code, but the historical development of the law in certain areas has disrupted the delicate balance of equity between debtors and creditors, particularly with respect to consumer credit transactions.

Other problem areas which need revision include agricultural-produce bailments, security repurchase agreements, real estate leasing and executory contracts-related bankruptcies and timesharing agreements. Extensive hearings were conducted on many of these concepts during the 97th Congress and we will continue to address these concerns today.

I would like to welcome all our distinguished witnesses today and I look forward to all their testimony.

Senator Dole. Thank you, Senator Heflin.

Senator Metzenbaum.

STATEMENT OF SENATOR HOWARD M. METZENBAUM

Senator Metzenbaum. Mr. Chairman, I want to commend you for moving into this subject at a very early date. Certainly it could hardly be earlier than this morning.

I don't think there is any problem that is of greater concern to the credit industry as well as to every industry than the fact that there is no law governing the handling of bankruptcy matters at the present time. So I think it is very important that the matter be resolved.

As a matter of fact, Mr. Chairman, you may recollect that when Congress debated the 1978 act I pushed very hard for resolution of that matter in a manner different than the way it came out. I supported article III judges with jurisdiction only in the area of bankruptcy. However, that was not acceptable.

Now we are in a situation where there is nothing that is the law. So I think it is important that we resolve it, whether along the lines of my original thinking or along the lines of somebody else's thinking. I think it is an area that calls for compromise and one that needs to be resolved at the earliest possible date. I am prepared to help in every way possible to expedite legislation to resolve that part of the problem.

Having said that, I think it would be a grievous error if the substantive changes which are a matter of more controversy were to be combined with the legislation having to do with the structure of the bankruptcy courts. I think it is in the area of the substantive changes that the greatest amount of dispute exists for some of us, but I think it doesn't bring out quite as much emotional reaction as does the question of jurisdiction, although I suppose that depends on whose ox is being gored as to whether it does or does not bring out that kind of emotion.

I would strongly urge that there be one bill on the jurisdictional questions and the matter of appointments and another bill having to do with the substantive questions themselves.

Addressing myself to the substantive questions, I think that we have made a good deal of headway in connection with the matter of changes in the law. I think my staff and the chairman's staff had resolved about nine different issues on a compromise basis. One was unresolved, and that was the question of what I call mortgaging the future income of the bankrupt.

Since the people are now aware of what that means, it is in this area that the greatest amount of controversy is apt to exist. Legislation to take care of a number of problems in the bankruptcy law has already passed the Senate, such as the shopping center tenancy amendments, which I supported, and the agricultural bailment legislation. We had no difficulty in passing them through the Senate, and I think those amendments are very important to certain segments of the economy.

I would, therefore, strongly urge that the issue of changing the consumer bankruptcy law doesn't lend itself quite that well to extended debate on the floor of the U.S. Senate, that it really should be worked out at the committee level if at all possible. I think those of us who are on the committee are more knowledgeable with respect to the substance of the legislation and maybe can comprehend its impact a bit more. I think that this issue does lend itself to compromise.

I will say to you that shortly I and other Members of the Senate will introduce a package which we hope will provide some amelioration of some of the problems about which some segments of the economy have been complaining.

I would further say to you that I have been in touch with the chairman of the House Judiciary Committee. If we are to pass legislation promptly, I think it important that we all work together, and I know Chairman Rodino has indicated a great willingness to work with me and some others in the Senate to try to effectuate a result that is fair and equitable to all parties.

So I am here this morning, Mr. Chairman, to indicate to you that I think we ought to have separate bills and I am prepared to work with you in finding a solution to the most urgent problem—the structure of the bankruptcy court. I am also willing to work with you in solving the substantive problems as well. I will work with you in that area to find a compromise.

Thank you.

Senator **Dole**. Thank you, Senator Metzenbaum. I don't disagree with what you say, but the realities are if we did have a separate bill, some would object without taking up other matters as well, and others would object to taking it up at all. There must be room for a compromise, although I haven't figured out what it is yet; if you do introduce legislation, that will give us an opportunity to explore areas of common interest.

I think Senator Heflin touched on a matter that must be addressed, and that is the *Manville* case. That is a case that Judge Heflin understands better than anyone on the committee and it is one that I think must be examined.

We have had brief hearings, and as you have indicated, Senator Heflin, it could be that we do need to redefine the term "bankruptcy." Hopefully, we can spend time on that issue early this year—I hope everything happens early this year, it happened so late last year. We are going to try to have our hearings very early for a couple of reasons.

First of all, we should; and, second, there are going to be a lot of hearings coming up in another committee that I serve on.

Senator **Metzenbaum**. I wonder which one.

Senator **Dole**. Finance.

Senator **Metzenbaum**. They may be both related.

Senator **Dole**. They may be before it is over, right.

We are very pleased to have this morning as our first witness Mr. Jonathan Rose. You may proceed in any manner you wish, but I would indicate that we have a number of witnesses, and to make friends here, you proceed promptly and summarize your statements.

Now, sometimes when you ask people to summarize, it takes longer to summarize than it does to read your statement, but hopefully if you could stress the primary points, since we have just so recently dealt with this issue, we do want to make a good record.

We may ask questions either today or in writing, and we will be working closely with the Justice Department almost immediately. Incidentally, I want to include in the record a statement from Senator Thurmond, who indicates he would like to move on this legislation quickly at the full committee level. I also wish to place in the record the statements of Senators Hatch and Baucus.

[The prepared statements of Senators Thurmond, Hatch, and Baucus follow:]

PREPARED STATEMENT OF SENATOR STROM THURMOND

The issues on which the subcommittee will be focusing on this morning are of great interest and importance to many individual Americans and to numerous corporations and small businesses. It is absolutely essential that our Nation have a stable and workable bankruptcy system, the constitutionality of which is unquestioned. Unfortunately, neither House was able to act in this important area during the closing days of the last Congress. Bankruptcy legislation is, therefore, a top priority of this committee and will be acted on very early in the 98th Congress. I would like to thank the distinguished chairman of the Subcommittee on Courts, Senator

Dole, for chairing this hearing and for beginning work on one of the most important issues of the new Congress.

As everyone here is probably aware, the Supreme Court declined to extend its stay of the effective date of the *Marathon* decision beyond December 24, 1982. The courts are currently operating under the interim rule promulgated by the Judicial Conference. That rule basically routes to the district court matters which *Marathon* would require to be heard by article III judges, but allows existing bankruptcy judges to continue to enter judgements and orders in core bankruptcy matters, subject to district court review. I commend the Judicial Conference for its prompt action in issuing this rule which should help to ease the confusion following expiration of the Supreme Court's stay. Congress must nevertheless act as soon as possible to restructure the present system for handling bankruptcy matters and place it on a firm constitutional footing.

In devising the best legislative solution to the jurisdictional issues identified in *Marathon*, I think Congress must balance the interests of our judicial system as a whole, considerations of costs, and the particular interests of those individuals and businesses in need of the bankruptcy services which the Federal courts provide. I would be happy to work with my colleagues in both the Senate and House and with all interested parties to secure passage of appropriate legislation.

In addition to those witnesses which will be addressing *Marathon* issues, the subcommittee will hear from a number of individuals with interests in other bankruptcy issues. The reforms in the Bankruptcy Code which these witnesses will discuss are important ones, and I think it is entirely appropriate to consider addressing these issues in the context of an omnibus bankruptcy bill which also deals with the jurisdictional issues.

I would like to thank all the witnesses who have agreed to testify here today. I am sure that the information provided will be a positive contribution to the understanding of these complex issues and will greatly assist the committee in its future deliberations.

PREPARED STATEMENT OF SENATOR ORRIN G. HATCH

Mr. Chairman, this summer, in *Northern Pipeline Construction Co.* v. *Marathon Pipeline Co.*, 102 S. Ct. 2858 (1982), determined that bankruptcy courts are prohibited by the Constitution from exercising the broad jurisdiction conferred upon them by the 1978 Bankruptcy Reform Act. The plurality and concurring opinions in this important constitutional ruling have left, however, many questions unanswered about the extent of bankruptcy jurisdiction vested in article I bankruptcy courts and article III district courts when the Court's stay on the *Marathon* decision was lifted on December 24, 1982.

Because the Constitution vests in Congress the authority to determine the bounds of jurisdiction in the lower Federal courts, it is incumbent upon us to resolve this confusion. In the absence of a congressional resolution, nearly every bankruptcy case will face costly delays as the courts struggle to define the authority of district courts over bankruptcy, to determine which kinds of bankruptcy issues may be delegated to the bankruptcy courts, and finally, to decide which kinds of delegated issues would have to be reheard *de novo* by the district courts following the bankruptcy court ruling. If Congress abdicates its constitutional duty to define lower court jurisdiction, the economic consequences could be catastrophic.

The Administrative Office of the U.S. Courts recently reported that more than 700,000 bankrupt estates and 100,000 bankruptcy adjudications are currently pending before the courts. Under the current uncertain circumstances, many of those cases may have to be litigated and litigated again until the courts develop a set of principles acceptable to the Supreme Court for the resolution of these questions of jurisdiction. Even the most optimistic scholars forecast months and years of judicial delay and confusion. Meantime neither debtors nor creditors, purchasers nor sellers of bankrupt assets, management nor labor of businesses attempting to reorganize under title 11 will be able to rely on the validity of bankruptcy decisions which may be subject to invalidation in the search for a last legal doctrine to settle jurisdiction questions. Perishable goods would spoil, employees would abandon hope and seek other jobs, valuable customers would find other suppliers, and the nation's economic woes could be further exasperated by Congress failure to provide a rule to govern these bankruptcies.

In the Constitutional Convention, Congress was given authority over lower Federal court jurisdiction to prevent exactly the kinds of dislocations likely to occur in the wake of the *Marathon* decision. After once voting to have no lower Federal courts whatsoever, the Convention decided to give Congress the authority to create subordinante Federal courts and set their jurisdiction. 1 M. Farrand, "The Records of the Federal Convention of 1787," (1911), at 124-125. The noted George Mason explained the Convention's reasons for giving Congress extensive authority to create lower Federal courts and adjust (or abolish) portions of their jurisdiction: He said simply that "many circumstances might arise not now foreseen, which might render such a power absolutely necessary." 2 Farrand at 46. In other words, Congress received power to set jurisdiction of the lower courts precisely because unexpected circumstances, such as a sudden rise in the bankruptcy caseload or an intervening Supreme Court decision, might arise calling for adjustment. Congress received this authority in order to facilitate a response for precisely the type of emergency currently occurring in the bankruptcy tribunals. To fail to act would, in my opinion, constitute a withdrawal from constitutional responsibility.

As this subcommittee, under the able leadership of its chairman, undertakes the responsibility of advising Congress on how to exercise its constitutional authority and resolve this crisis, we should also devote attention to several needed revisions in the bankruptcy code. Several of the needed revisions have already been eloquently addressed by the chairman of this subcommittee and witnesses before hearings on reform of the bankruptcy code in the 97th Congress. For instance, many noted scholars called attention to the need for some recognition of the current income level of an individual filing for bankruptcy when making the determination of his ability to satisfy some obligations without recourse to the court system. Although cases when such a recognition of present income could prevent abuse of the bankruptcy remedy may be limited, many scholars have nonetheless contended that this would be an important legal check to insure that the bankruptcy is indeed only a "final recourse" for a debtor without other opportunities to satisfy his creditors.

In the 97th Congress, I introduced two other measures that deserve consideration of this body. Since those two items are included in today's hearing schedule, I would like to especially thank the subcommittee chairman for his attention to the vital issues of bankruptcy and these two issues.

As I mentioned, last year Senator DeConcini and I introduced S. 2297 to remedy serious problems faced by many shopping centers and their solvent tenants by the administration of the code. Hearings were held by the Subcommittee on Courts, on S. 2297, on May 3, 1982.

On May 21, 1982 it was approved by the subcommittee for full committee consideration. The full Senate Judiciary Committee approved the bill and ordered it favorably reported on August 4, 1982. S. 2297 was passed unanimously in the Senate on October 1, 1982.

Mr. Chairman, shopping center tenants are inextricably tied together. When one suffers financial failure, others may be placed in jeopardy as well if our bankruptcy code does not insure an efficient arrangement to fill the shopping center's vacancy. Prior to 1978 this was accomplished by lease clauses allowing the lessor to regain control of the lease in the event of bankruptcy. The 1978 act made such lease clauses unenforceable. Instead the lease becomes a part of the bankrupt estate. This can create acute problems when the estate's administrator neither assumes or assigns the lease for several months. The surrounding shopping center tenants must bear the extra burden caused by the vacancy—a particularly difficult problem if the shopping center was built around a single major business which has now folded. A single bankruptcy could trigger others. S. 2297 established a 60-day time limit for the administrator's decision to assume or reject a lease. This gives an administrator some incentive to either find a new tenant himself or return the lease to the shopping center within a reasonable period of time. The fate of the shopping center will not hang in the balance until the estate is settled.

In addition, the bill addressed a few other problems. In the event the lease is assumed by the administrator, it may be assigned to a business not in compliance with the use limitations of the lease, not of the financial quality required by the center, or which does not pay the customary security deposit. For example, a men's shoe store may have entered a shopping center lease on the understanding that all men's shoe stores would pay identical rent. Assigning a women's shoe store lease at a lower rent to a fourth men's shoe store would both oversaturate the men's shoe market and give the fourth store the unfair advantage of a lower overhead. This only illustrates one of the complexities of shopping center bankruptcies.

The witnesses appearing before this hearing on behalf of the shopping center amendments will testify that there is still a pressing need for change in the Bankruptcy Code in this area. I also endorse in the 98th Congress the objective of S. 2297 and will introduce the bill again as soon as the parliamentry situation allows introduction of bills.

In the past Congress I also introduced S. 3027 (97th Cong.), a bill to amend the Bankruptcy Act regarding executory contracts, and for other purposes.

Mr. Chairman, this is another area of the Bankruptcy Code that needs to be amended. Since the early 1970's an industrial phenomenon has swept the United States. Americans, finding the cost of full time ownership in resort and vacation accommodations too expensive, have shifted to purchasing timeshares in resort condominiums, hotels, campgrounds, and various other real estate. The timeshare industry has grown, from as few as eight resorts in 1972, into a $1.5 billion industry soon to have 825 resorts with more than 25,000 units. A timeshare is a right, which the purchaser buys, to use a property for a designated length of time each year. There are two broad categories of time shares. One where the person buys an ownership interest in real estate (the building and common areas) and another where the person buys a right to use the living space for a specific number of years but does not have ownership interest in the real estate. This latter category has been given the title of "right-to-use" timeshares.

This rapid growth of the timeshare industry in a relatively short period of time has left some of our traditional real estate laws incompatible with time sharing. Section 365 of the Bankruptcy Code provides that a trustee in bankruptcy or debtor-in-possession may "assume or reject any executory contract or unexpired lease of the debtor." Last year in the case of *Sombrero Reef Club, Inc.* v. *Allman,* 18 B.R. 612 (Bkrtcy. S.D. Fla. 1982), the court held that the right-to-use timesharing contracts used at Sombrero Reef were executory and allowed the debtor-in-possession to reject them. That holding presents significant problems for the consumer who is thereby relegated to the position of a general, unsecured creditor of the resort. A consumer would practically forfeit his investment permitting the resort to sell the property without obligation. In the case of the *Sombrero Reef Club,* the consumer would lose their original purchase price of $1,000 to $3,000 plus a yearly fee of around $80.

The threshold question in a rejection case is if a contract is executory. The most widely accepted definition of an executory contract for bankruptcy purposes is a contract "under which the obligation of the bankrupt and other party is so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." The *Sombrero Reef Club,* case clearly gave the right-to-use contracts the status of executory. In other words, the courts ruling permits the resort to reject right-to-use contracts in bankruptcy cases.

Mr. Chairman, in the interest of the consumer in this rapidly expanding industry my bill would have done the following things:

(1) Added section L to section 365 of the Bankruptcy Code providing for a separate treatment for timeshare situations.

(2) Clause one of section L would have provided if the trustee rejects an executory contract of the debtor the purchaser may treat such contract as terminated and receive a lien on the interest in the timeshare for the price he has invested. In the alternative, the purchaser may continue to exercise his right to use and occupy the timeshare premise to the extent provided for in the contract. This option, however, must be exercised within a specified time period.

(3) Clause two of section L would have provided that the purchaser may offset payments if after rejection any damages accrue due to the nonperformance of obligations of the debtor.

(4) Clause three of section L provided a definition of timeshare plan, timeshare interest, and timeshare premises.

(5) Amends section 365(F)(2) to provide in a situation where the trustee has assigned the contract to a third party that a purchaser may have the option to terminate his contract rather than participating with the assignee in the resort.

(6) Amended section 544(a)(3) to anticipate the argument that the trustee could attempt to void the contract containing the nondisturbance language as a transfer in real property, eliminating the protection preserved in section L(1).

(7) Made the necessary amendment to section 365(a) for the insertion of (L) into the listed paragraph.

Mr. Chairman, I feel that both S. 2297 and S. 3027 are still solutions to the specific problems in bankruptcy reform that I have mentioned above. I recommend that as this subcommittee considers reform in the bankruptcy laws they will favorably include these provisions which I have mentioned in their report to the full committee. I feel in so doing we can begin the legislative process towards this much needed reform in our bankruptcy laws.

Once again, I heartily commend the subcommittee for undertaking this important task of addressing the desperate situation in our bankruptcy system. At the same time, I am grateful that the subcommittee has seen fit to consider a few changes in the Code that are clearly warranted.

Prepared Statement of Senator Max Baucus

First, I'd like to take this opportunity to commend Senator Dole and Senator Heflin for acting so promptly in the 98th Congress to have hearings on bankruptcy reform. It seems beyond question that numerous changes are needed to make our bankruptcy system more reasonable and equitable for all interested parties. And the more quickly the Judiciary Committee considers and reports substantive bankruptcy reforms, the more likely they are to become law this year.

I am particularly pleased that this hearing includes consideration of the issue of grain elevator bankruptcies. Although there has been widespread recognition in the Senate that remedial legislation is needed in this area, I think it is important that we reaffirm our commitment to finding legislative solutions to the problems caused by existing laws.

There can be no doubt that the well-being of the American farming community is vitally important to the well-being of this country as a whole. But in today's hard economic times, farmers seem to be suffering inordinately, and in many cases they are losing property that has been in their families for generations. Under these circumstances, it is totally unacceptable for Congress to ignore the need to change federal laws that exacerbate, rather than alleviate, farmers' economic hardships.

The problems presented to farmers by grain elevator bankruptcies were vividly illustrated by the financial failure of the Coast Trading Company a few years ago, a failure which had disastrous effects on farmers in my home State of Montana, as well as in Washington, Oregon, Idaho, and the Dakotas. Millions of bushels of grain stored by the farmers in the company's warehouses were tied up for years in bankruptcy litigation. During these years, the affected farmers had no way of getting money for the crops entrusted to the company, and without that money, many were unable to plant new crops or repay loans previosuly undertaken to meet the high operating expenses of farming.

We may not be able to change the inequities of the past, but there is no excuse for perpetuating a system that allows the lives and dreams of one group of people to be destroyed by the mismanagement or bad fortune of another group over whom they have no control.

On four previous occasions, the Senate has considered legislation to make the law on grain elevator bankruptcies fairer to farmers. On four previous occasions, that legislation has passed the Senate but failed to win approval in the House. I consider it one of this year's highest priorities that substantive reforms in this area become law.

Mr. Chairman, at this point I would ask that there be included in the record a copy of an article entitled "Effects of Collapse Starting to Appear," which appeared in the Great Falls Tribune on November 21, 1982. Thank you.

[Newspaper article follows:]

[From the Great Falls (Mont) Tribune, Nov. 21, 1982]

Effects of Collapse Starting to Appear

(By Keith Haugland)

NEWS ANALYSIS

Although the full effects of Coast Trading's collapse will not be known for several years when court cases are finally settled, it is possible to partially fill in a scorecard on the winners and losers.

Aside from Coast Trading itself, the biggest losers of course are the individuals caught in a web spun by volumes of court documents filed since last April.

In Montana, it means that more than 100 Montana farmers and grain traders, as unsecured creditors, will initially receive only 30 percent of the more than $3.8 million owed them.

Later some will receive another 5 cents on the dollar that will come from the $215,000 in bonds held by the state Department of Agriculture.

But the money from the bonds, according to Gordan McOmber, agriculture department director, cannot be distributed until much, if not all, litigation is completed.

Some Montana creditors could receive all their money back if they can convince the bankruptcy court that they deserve priority of some sort. But to do that, attorneys have to be hired both in Montana and Oregon.

Members of the creditor's committee, chosen from among the 10 largest unsecured creditors, have also spent hundreds of hours in meetings, travel and in court.

Gib Goodman, Helena, the chairman of the committee, has attended every meeting and hearing at an expense well in excess of $4,000. Goodman and other committee members hope to get expenses back, but have not received payment yet. In addition, Goodman is awaiting his 30 percent of the more than $100,000 owed him by Coast Trading.

Jerome Shulkin, the bankruptcy specialist representing unsecured creditors, said he has never worked with a more dedicated creditors' committee. He also had special praise for Goodman's dedication and ability.

The company which appears to lose the most is Sumitomo Corp. of America, a subsidiary of a huge financial complex in Japan.

Wishing to establish itself in the grain business here, Sumitomo purchased 40 percent of Coast Trading's stock from William Macdonald and Tom Curtin, the two major stockholders in the company. The proceeds of the sale went directly to the two and not to the grain company. Now Sumitomo, according to Shulkin, is out $9 million.

Other losers include Coast Trading employees. Some have lost their jobs in recent months, while the rest wonder if they will be retained by the new company taking over.

Ken Brandvold, Great Falls, who was manager of Coast Trading's operations in Montana and North Dakota, said the months since the bankruptcy filing April 7 have been a nightmare. Now that a new company will likely take over the facilities, Brandvold naturally wonders if he will be a part of that operation.

Secured creditors, such as Coast Trading's banks with secured claims, will fare better. They will receive their money back, plus interest, expenses and attorneys fees.

Other secured creditors with lower priorities will also receive their money back, but over a period of five years.

Macdonald and Curtin, although they have lost their grain company, still have the $9 million in stock sales.

And the big winners, according to one grousing creditor, are the lawyers. "A lot of lawyers kids are going to get a college education out of this mess," the man said.

NORTHERN PIPELINE CO. V. MARATHON PIPELINE CO. DECISION

Senator Dole. Mr. Rose.

STATEMENT OF JONATHAN C. ROSE, ASSISTANT ATTORNEY GENERAL, DEPARTMENT OF JUSTICE

Mr. Rose. I will submit my longer statement for the record and hit the high points, if I might, because we have changed our position only slightly.

Since I last appeared here, the Supreme Court denied our request for an extension of the stay in the *Northern Pipeline* case. We are, therefore, now operating unsatisfactorily under an interim rule promulgated by the Judicial Conference.

As indicated at the meeting here at the Senate a few weeks ago, problems are already developing. Creditors are refusing to advance new money to businesses in reorganization because they doubt the authority of the bankruptcy judges under the interim rule. Bankruptcy judges are refusing to enter necessary orders for fear of personal liability. If we continue to delay needed legislation, we are engaging in a game of legislative and economic Russian roulette.

As we have said earlier, the administration does not support legislative enactment of the interim rule as bills proposed by Senator Heflin and Representative Kastenmeier would do. These bills would be subject to similar kinds of constitutional infirmities as *Northern Pipeline* case found in the 1978 act and will continue to have the kind of uncertainty we have today.

Once one decides that an article III approach is required, there are now three different alternatives to consider. Two of these alternatives—reflected in H.R. 7294 and H.R. 6978 in the last Congress—were the subject of my testimony in November.

H.R. 7294 would provide for the appointment of 227 additional district judges to sit in newly created bankruptcy divisions of each district court. These district judges would be assigned principally to hear bankruptcy matters, but would be available to hear other matters before the district courts to the extent that bankruptcy matters did not require their full time.

H.R. 6978, as reported by the House Judiciary Committee, was similar in approach except that it would create an independent bankruptcy court in each district. H.R. 6978 has been reintroduced with certain amendments as H.R. 3.

Since my testimony last November a new approach has been suggested by the Judicial Conference of the United States. This second Judicial Conference proposal, which came too late for active consideration by the last Congress, represents, in our view, a better solution to the bankruptcy court crisis than the others that Congress has thus far considered. I will discuss this alternative first before turning to those considered last fall.

Under the Judicial Conference's proposal a bankruptcy administrator would be appointed in each judicial district to supervise all bankruptcy cases and proceedings. In addition, the administrator would be authorized, with the consent of all parties, to approve routine filings with the court and to grant many other uncontested motions. This would relieve the judges of the burden of managing bankruptcy cases and approving uncontested matters. However, the bankruptcy administrator would not be authorized to resolve disputes among the parties or to grant contested motions.

All contested matters in bankruptcy proceedings would be referred by the bankruptcy administrator to the district court for resolution. The administrator would also be able to lodge objections to a matter presented to him, which would also be determined by the district court. This would assure that all contested bankruptcy matters are decided by district judges—or by a magistrate, if the parties have so consented.

Under this proposal the judges' role would be limited to resolving live disputes on the facts or the law. The routine administration of the large numbers of uncontested bankruptcies would be appropriately left to the bankruptcy administrator.

To handle the increased workload on the district courts, the bill provides for the appointment of 115 additional district judges in the various districts. These judges are in addition to the 51 additional district and circuit judges recommended by the Judicial Conference to handle the existing backlogs of civil and criminal cases.

The proposal also would amend the Magistrates' Act, 28 U.S.C. 636, to authorize magistrates to perform the same functions in bankruptcy cases that they presently do in civil and criminal cases. The magistrates would not be permitted to enter any dispositive orders in bankruptcy cases unless the parties have consented to allow a matter to be decided by a magistrate.

This proposal, we believe, provides a very favorable framework for a sound long-term solution to the current bankruptcy crisis. The appointment of article III district judges to adjudicate all contested bankruptcy matters will resolve any constitutional doubts with respect to matters decided by them.

At the same time, fewer new judges would be required under this proposal because judges would not be required to consider the numerous routine motions and reports that arise in all bankruptcy cases, as long as no party objects. This would result in the more efficient use of judicial manpower and would avoid the creation now of new judgeships which might not be warranted in the years ahead.

This proposal would, we believe, be considerably less expensive than the proposals considered last year calling for the creations of 227 article III judges to staff a separate bankruptcy court or a bankruptcy division of the district courts. The 227 judges proposed by these bills reflect the approximate number of existing judges—229 full-time and 12 part-time bankruptcy judges are currently authorized.

The caseload figures reported by the Administrative Office to Congress on December 30, 1982, however, reveal that 304 bankruptcy judges would be needed to handle the current caseload, assuming that the jurisdiction established by the 1978 Bankruptcy Reform Act were maintained. Thus, if Congress determines to address this problem by creating a separate article III bankruptcy court to handle the duties of the former article I bankruptcy court, it may be compelled by the current caseload to create 304 lifetime article III judges to handle bankruptcy matters rather than the 115 proposed by the Judicial Conference.

Thus, we urge that the subcommittee give favorable consideration to this new proposal. I would note that we believe this proposal could be improved by the inclusion of provisions to assure that contested bankruptcy matters are not denied a prompt resolution because of a backlog of civil or criminal cases. The general approach of the bill, however, is sound. We would be pleased to work with the subcommittee to refine these provisions of this bill.

With respect to the earlier proposals to create bankruptcy divisions of the district courts or independent bankruptcy courts to adjudicate bankruptcy matters, my comments presented by the November 10 hearing are equally applicable here.

In summary, we prefer the approach reflected in H.R. 7294, which would create bankruptcy divisions as part of a unified Federal district court. The 227 additional district judges would sit in the bankruptcy division principally to handle bankruptcy matters. To the extent that they were not required full time to handle bankruptcy matters, the judges would be available for assignment to hear other cases in the district court or to sit on other courts by designation.

This approach would assure that bankruptcy matters will be handled promptly and expeditiously by article III district judges familiar with bankruptcy law and serve to keep bankruptcy matters separate from the backlog of civil and criminal cases in the district court. At the same time, the approach would allow the efficient integration of the workload and judicial resources of the courts, under the general management of the chief judges of the district and the circuit, by allowing assignment of nonbankruptcy matters to bankruptcy division judges when this will not interfere with the expeditious handling of bankruptcy matters.

We believe that it is far less desirable to take the approach of creating an entirely separate article III court composed wholly of lesser compensated judges to hear only bankruptcy cases to be in place by October 1985. In our view such a solution speeds the trend toward a fragmented judiciary and runs the serious risk of leaving us at some future point with a cadre of less qualified, underutilized lifetime judges on the Federal Bench.

For these reasons we favor the approach advocated by the Judicial Conference.

Mr. Chairman, that concludes my summary remarks. I will be glad to answer any questions.

Senator DOLE. Thank you.

Senator Heflin.

Senator HEFLIN. I haven't had an opportunity yet to review the Judicial Conference and the Justice Department's recommendation and I apologize for that, but we do have other things, and we have been in recess and I think it is more important that I keep in touch with my people during recesses than to read changing philosophies and changing recommendations that the Department of Justice and the Judicial Conference might come out with.

Let me ask you some details first.

You recommend the creation of a bankruptcy administrator for each district court. Am I correct in that?

Mr. ROSE. That is correct, Senator Heflin.

Senator HEFLIN. This is a new position. Why are you creating a new judicial official rather than designating a magistrate as an administrative magistrate for bankruptcy?

Mr. ROSE. Well, I think the response is that there has been tremendous concern that if we did not provide a full number such as 227 or 300, depending on which figures you used, bankruptcy judges, the bankruptcy cases would be neglected by the existing judicial system.

The thought was if we created an upgraded administrative officer to do things that bankruptcy judges now do, but that are primarily administrative in nature, that those fears on the part of the bankruptcy bar should be relieved. It was thought it was necessary to combine some of the functions that a deputy clerk for bankruptcy now does, take some of the functions that a bankruptcy judge now does which are rather ministerial in nature and create an office which would be a judicial office, but obviously less than a lifetime judge, to which we could attract high-caliber people.

I think it was a combination of those factors which led the Judicial Conference to propose that kind of solution.

Senator HEFLIN. I was asking not as to a full-time judge—I mean, as to a full-time, lifetime judge, but as to a magistrate.

Technically under the authorities that magistrates have, would it not be in effect more feasible to have a magistrate performing those and certainly the quasi-judicial or judicial functions that the bankruptcy administrator might be performing, and there would then be less question about the legality of those functions, would there not?

Mr. Rose. Well, I don't think so. I think there was tremendous reluctance, given the existing criminal and civil caseload, to tamper too much with the functions of the existing magistrates which seemed to be working pretty well. It was perceived that we had a particular problem here in bankruptcy, and that what we needed to do was to devise a group of people, some of whom would be lifetime judges, particularly as compelled by the *Marathon* decision; and some others that could do things the bankruptcy judges now do, and those would be bankruptcy administrators.

If we started involving the magistrates in that, we might, in effect, be robbing Peter to pay Paul and disrupt that which was going well.

I think this was basically the thinking, although I must tell you that it was not our office that originally came up with this precise solution.

Senator Heflin. Have you made any calculations of a cost estimate of what the proposal that you recommend would cost?

Mr. Rose. We made some initial calculations and planned to get into this more thoroughly. It seemed obvious to us that when you lowered the number of lifetime judges that you would be requesting to somewhat less than half, that would be a tremendous cost saving. To be sure, you would be talking about in the form of these bankruptcy administrators the addition of some salaried officers, but these would be nontenured officers or at least they wouldn't be lifetenured officers, so there would be a considerable saving just from knocking down at least in the initial stage the number of judges requested. Frankly we wanted to come in with as low a request for additional judges as possible, recognizing that this gets involved in political situations, and we think we are beyond the need to debate this politically.

We really need to have a solution to the bankruptcy problem.

Senator Heflin. I believe we have a total of 241 bankruptcy judges today. If you create 115 district court judges and then 100 magistrates—bankruptcy magistrates to work with them, that is 215.

How many people would become involved in this bankruptcy administrator's office? Would you transfer from existing clerks?

Mr. Rose. I think you could in a number of cases have that. It is the 227 that the 115 would be replacing. So you would be wiping that group out over time. You would have one presumably bankruptcy administrator per district unless the volume of filings was so low that they didn't even justify having a bankruptcy administrator, and I assume some of those people would be the current deputy clerks and it would be an upgraded function.

Senator Heflin. Can your office make some sort of calculation of present administrative personnel within the bankruptcy court in comparison to what the new proposal might do?

Mr. Rose. Sure. We would have to work with the administrative office of the U.S. courts, but we would be more than pleased to do that for the committee.

Senator Heflin. Many of the bankruptcy issues are fairly routine and can be taken by some judicial official. You called him a bankruptcy magistrate under the Supreme Court decision without getting into a serious constitutional question.

On the other hand, magistrates could relieve U.S. district court judges of some of the mundane and routine type of decisions, which involves the issue of consent, and the magistrates bill that we passed a couple or 3 years ago allows for magistrates to try almost any type of civil case and some criminal cases, provided consent is given.

In order to have an expeditious handling of this there have been some suggestions that consent be obtained by negation rather than affirmation, that if within a certain period of time if a party did not request that a district court judge hear the case and enter the judgment, that consent was presumed.

What is your feeling relative to that, as to whether or not within a certain period of time if somebody has not, in effect, demanded that a district court judge hear the case, that consent would be presumed after the passage of time, a certain period of time, or certain filings of papers, and then that magistrates, or bankruptcy magistrates or bankruptcy judges, whatever you might end up calling them, could proceed to try those cases.

Mr. ROSE. Well, I guess I, like you, have been through those silence is presumed to be consent cases. I would have no inherent personal objection to it. I would want to go and look at analogous situations to make sure we had a valid proceeding that was not going to be capable of being upset.

If that kind of procedure could be adopted and we are not likely to be invalidated several years later, then I would say that would be fine.

Senator HEFLIN. It is similar to a demand for trial by jury. If the parties within certain paper filings or time, depending on jurisdiction or wherever you may be, State courts or Federal courts, if there is no demand for a trial by jury, then it is tried nonjury.

It is a similar sort of thing. It is a presumption of consent after an opportunity to demand a jury trial or to demand a U.S. district-judge-hear-the-case approach.

I don't think there is any constitutional impairments, but it is a question of fairness and we all want to give everybody an opportunity to be able to have that.

I believe that is all.

Senator DOLE. You indicate in your testimony that you will be pleased to work with the subcommittee to develop this. Is this a midcourse correction? [Laughter.]

Mr. ROSE. I don't think that I want to touch that, Mr. Chairman. It was the Judicial Conference seeing the light and our ability to work with them.

Senator HEFLIN. You don't believe in staying the course?

Mr. ROSE. We believe in being pragmatic.

Senator DOLE. Does the Chief Justice support this proposal?

Mr. ROSE. I believe so. I don't know who the Judicial Conference precisely represents, except I believe it is all the judges; so I assume he certainly does.

Senator DOLE. I think what we will do is review very carefully the plan, because I am not certain anybody knows how it works, which means it might work. [Laughter.]

I believe the cost may not be the only factor involved. It seems to me we ought to focus more on efficiencies of the proposed system.

In any event, I think there are so many factors involved that you are probably not talking about much difference in cost.

I think you indicate in your statement we need to find a solution and do it quickly. Maybe it is too early to indicate, but have you had a chance to meet with Chairman Rodino and others on this new proposal?

Mr. **Rose**. We have had a chance to discuss this kind of proposal, and I think it is fair to say that the chairman and many members of the bankruptcy bar, given the history of what has transpired in the past, would prefer a separate court. They feel that that assures treatment of the bankruptcy matters with the highest priority, and that to subject bankruptcy matters to the broad supervision of the district courts would not assure the kind of priority treatment that they would like.

I think this proposal represents a good-faith attempt by the Judicial Conference to provide the kind of manpower and the kind of personnel that would achieve the kind of treatment they want without in the view of the Judicial Conference creating a very large separate court and specialized courts which would produce a lot of the problems they fear.

We would like to give the Judicial Conference proposal a try.

A second real advantage of the Judicial Conference, it seems to us, given its fewer number of judges and its greater flexibility, is that if we make a mistake, it can be fixed by a future Congress. Once you move down the road of a separate court with lifetime judges, it is very hard to fix that. That is why we believe this approach ought to be given a try, and then if it doesn't work, another Congress could come back and fix it.

Senator **Dole**. What would you pay an administrator? Has this been determined?

Mr. **Rose**. I think the high level of GS. He would have to be a type of person who could do this work and would be able to be recruited at the high levels of Federal Service.

Senator **Dole**. That would be somebody other than a Senator. We are at a lower level. [Laughter.]

Mr. **Rose**. That is a source of continuing embarrassment for us all.

Senator **Dole**. We are in a position of paying staff more than we are paid. I don't quarrel with staff, but I find that hard to do.

Senator **Heflin**. Do not do it.

Senator **Dole**. I have not yet. All right, I think there will be other questions and other plans to look at, but I think this makes some sense and we certainly will be working with you to try to put something together very quickly.

I know we will have the cooperation of the committee on this one issue. I think in other areas, as Senator Metzenbaum indicated, there is a difference of opinion, at least in the one particular area, but as I understand it, you wanted to limit your testimony strictly to the Marathon problem, and if you have comments on other areas we would be pleased to have those.

Mr. **Rose**. As I have indicated to your staff, we are sympathetic to the other provisions you have sponsored and the only problem has been one of tactic as to how they can best be moved, and we are certainly willing to work with you on what makes sense on that.

Senator **Dole**. Thank you very much.

Mr. **Rose**. Thank you.

[The prepared statement of Mr. Rose follows:]

PREPARED STATEMENT OF JONATHAN C. ROSE

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear again before you to present the views of the Department of Justice with respect tc legislative proposals to restructure the Nation's bankruptcy court system. As you are well aware, the Supreme Court's decision in Northern Pipeline Construction Co. v. Marathon Pipe Line Co., 102 S. Ct. 2858 (1982), has determined that the system of adjunct bankruptcy courts created by the 1978 Bankruptcy Reform Act cannot constitutionally exercise the broad jurisdiction conferred on them by that Act. The Supreme Court's stay of that decision expired on December 24, 1982, and the Court denied the Solicitor General's motion for a further stay. As a result, the bankruptcy court system established by the 1978 Act is no longer functioning.

I.

In its place, the district courts are operating under an Emergency Rule proposed by the Judicial Conference and adopted by each district court. But this Rule is only a stopgap at best. In light of existing case burdens on the district courts, we do not believe that bankruptcy matters can be effectively handled by the district courts for any extended period of time under the Emergency Rule.

As I noted in my November 10, 1982, testimony, it is quite unclear exactly how the Rule will operate in adjudicating the many kinds of issues that arise in or are related to bankruptcy matters, or whether the Rule will, in its applications, be found consistent with the requirements of the Northern Pipeline decision. Though the United States does not intend to challenge the general validity of the Rule as a litigant, others already have and more surely will. A definitive construction of the Rule by the courts, perhaps by the Supreme Court, will come only after months or years of litigation. Regardless of whether various aspects of the Rule are ultimately upheld or disallowed, the lingering uncertainty during that lengthy period of judicial construction will have a debilitating effect on bankruptcy litigants, the bankruptcy system itself and, indeed, upon the entire economy.

In the four weeks since the expiration of the Supreme Court's stay, evidence of practical problems under the Emergency Rule has only begun to come in. But the trend of these early indications is decidedly troubling. At a recent conference on January 7, 1983 -- not even two weeks after the Emergency Rule took effect -- a number of distinguished bankruptcy practitioners and judges indicated various problems with the Emergency Rule that were already beginning to mount. I will not belabor the examples described at that conference, but a few deserve brief mention.

In several specific cases, creditors have refused to lend new money to debtors based on a bankruptcy judge's order, and title insurance companies have refused to rely on a bankruptcy judge's order that a debtor's property can be sold free of encumbrances. In other cases, attorneys have apparently taken the position that the automatic stay contained in Section 362 of Title 11 is of no further force and effect because the bankruptcy court has no constitutional jurisdiction to enforce the stay. Disputes over whether certain matters are "related proceedings," which must be reviewed de novo by the court, have arisen in other instances. Although the availability of a district judge to enter the necessary orders may ultimately resolve most such problems, the inevitable delay required may well disrupt a debtor's reorganization process where prompt refinancings and sales of excess property are essential. At best, the Rule will give undue leverage to litigants who can take advantage of the delay resulting from objections to the jurisdiction of the bankruptcy judge.

The practical problems under the Emergency Rule are not limited to the parties to bankruptcy proceedings. At the

January 7 Conference, several bankruptcy judges indicated that, because they cannot claim the absolute immunity of Article III judges and could be held personally liable for civil damages for actions taken in excess of their proper jurisdiction, they would decline to enter final orders in matters involving large sums of money. At least one bankruptcy judge has apparently declined to enter any final orders in this ground. Some standing trustees in Chapter 13 cases have indicated a reluctance to make payments from funds held in trust on the basis of a bankruptcy judge's order.

Thus, parties to bankruptcy proceedings are increasingly resorting to the district courts for the entry of necessary orders. At best, this added burden on the district courts in some districts can be accommodated with only relatively minor delay in the bankruptcy proceedings or in other civil and criminal matters. In other districts, given substantial backlogs in civil and criminal matters and insufficient numbers of judges, the increased bankruptcy caseload will threaten all litigants with intolerable burdens.

In short, although the Emergency Rule may well be the only feasible response by the courts to the extreme circumstances created by Northern Pipeline, it is and must be only a short-term measure. Prompt action by Congress to restructure the bankruptcy court system is essential to return that system to a sound and workable basis.

II.

When I testified before you last November, I explained our objections to legislation which would attempt to confer substantial bankruptcy jurisdiction on an Article I bankruptcy court, such as the first proposal advanced by the Judicial Conference in September. It is one thing for the courts to adopt the Emergency Rule on an interim basis until Congress can legislate a new court system. It would be quite another matter for Congress to attempt as a permanent solution the re-establishment of an Article I court which presents most of the same uncertainties and litigation problems as the Emergency Rule.

In addition to resurrecting many of the problems of bifurcated jurisdiction which the Bankruptcy Reform Act of 1978 sought to solve, such an Article I solution would rest upon the speculation that a very narrow construction of Northern Pipeline ultimately will prevail in the Supreme Court. Until such a definitive ruling, the possibility of a new ruling that the grant of jurisdiction to Article I bankruptcy judges is unconstitutional would cast a shadow on all bankruptcy cases.

As I indicated in my earlier testimony, it is our view that a legislative proposal which simply offers an opportunity for more litigation to test its constitutional validity is no solution at all. The appointment of Article III judges will resolve any constitutional concerns, allow the consolidated disposition of all related bankruptcy matters, and attract the highest caliber of lawyers to the bench.

III.

Once a decision is made in favor of appointing Article III judges to determine bankruptcy cases and proceedings, there are several different alternatives to consider. Two of these alternatives -- reflected in H.R. 7294 and H.R. 6978 in the last Congress -- were the subject of my testimony in November. H.R. 7294 would provide for the appointment of 227 additional district judges to sit in newly-created bankruptcy divisions of each district court. These district judges would be assigned principally to hear bankruptcy matters, but would be available to hear other matters before the district courts to the extent that bankruptcy matters did not require their full time. H.R. 6978, as reported by the House Judiciary Committee, was similar in approach except that it would create an independent bankruptcy court in each district. H.R. 6978 has been reintroduced with certain amendments as H.R. 3.

Since my testimony last November, a new approach has been suggested by the Judicial Conference of the United States. This second Judicial Conference proposal, which came too late for active consideration by the last Congress, represents, in our view, a better solution to the bankruptcy court crisis than the others that Congress has thus far considered. I will discuss this alternative first before turning to those considered last fall.

A.

Under the Judicial Conference's proposal, a bankruptcy administrator would be appointed in each judicial district to supervise all bankruptcy cases and proceedings. In addition, the administrator would be authorized, with the consent of all parties, to approve routine filings with the court and to grant many other uncontested motions. This would relieve the judges of the burden of managing bankruptcy cases and approving uncontested matters. However, the bankruptcy administrator would not be authorized to resolve disputes among the parties or to grant contested motions.

All contested matters in bankruptcy proceedings would be referred by the bankruptcy administrator to the district court for resolution. The administrator would also be able to lodge objections to a matter presented to him, which would also be heard by the district court. This would assure that all contested bankruptcy matters are decided by district judges (or by a magistrate, if the parties have so consented). Under this proposal, the judges' role would be limited to resolving live disputes on the facts or the law. The routine administration of the large numbers of uncontested bankruptcies would be appropriately left to the bankruptcy administrator.

To handle the increased workload on the district courts, the bill provides for the appointment of 115 additional district judges in the various districts. These judges are in addition to the 51 additional district and circuit judges recommended by the

Judicial Conference to handle the existing backlogs of civil and criminal cases.

The proposal also would amend the Magistrates' Act, 28 U.S.C. § 636, to authorize magistrates to perform the same functions in bankruptcy cases that they presently do in civil and criminal cases. The magistrates would not be permitted to enter any dispositive orders in bankruptcy cases, unless the parties have consented to allow a matter to be decided by a magistrate.

This proposal, we believe, provides a very favorable framework for a sound long-term solution to the current bankruptcy crisis. The appointment of Article III district judges to adjudicate all contested bankruptcy matters will resolve any constitutional doubts with respect to matters decided by them. At the same time, fewer new judges would be required under this proposal, because judges would not be required to consider the numerous routine motions and reports that arise in all bankruptcy cases, as long as no party objects. This would result in the more efficient use of judicial manpower, and would avoid the creation now of new judgeships which might not be warranted in the years ahead.

This proposal would, we believe, be considerably less expensive than the proposals considered last year calling for the creation of 227 Article III judges to staff a separate bankruptcy court or a bankruptcy division of the district courts. The 227 judges proposed by these bills reflects the approximate number of existing bankruptcy judges (229 full-time and 12 part-time bankruptcy judges are currently authorized). The caseload figures reported by the Administrative Office to Congress on December 30, 1982, however, reveal that 304 bankruptcy judges would be needed to handle the current caseload, assuming that the jurisdiction established by the 1978 Bankruptcy Reform Act were maintained. 1/ Thus, if Congress determines to address this problem by creating

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1/ Director of the Administrative Office's Report to Congress of December 30, 1982, pursuant to § 406 of Pub. L. No. 95-598.

a separate Article III bankruptcy court to handle the duties of the former Article I bankruptcy court, it may be compelled by the current caseload to create 304 lifetime, Article III judges to handle bankruptcy matters, rather than the 115 proposed by the Judicial Conference.

An important advantage of the new proposal advanced by the Judicial Conference is that it would not cause the major transformation of the character of the Article III judiciary that would result from the creation of a specialized bankruptcy court. The creation of a separate bankruptcy court would greatly expand the numbers of Article III judges with the infusion of a large contingent of specialized judges whose practice, background and orientation would tend to be significantly different from those of the existing federal judges of general jurisdiction.

It is very clear to us that it will be extremely difficult to find candidates of the same experience and abilities as existing federal judges to assume specialized bankruptcy judgeships, particularly if they are to be limited exclusively to bankruptcy matters and compensated at a rate less than other federal district court judges (as is provided by H.R. 3). We are convinced, moreover, that the broad bankruptcy jurisdiction created by the 1978 Bankruptcy Reform Act requires judges of the highest caliber. Bankruptcy matters are often highly complex and of extreme importance to the economic life of our country. To adjudicate all matters "related to" bankruptcy cases under the 1978 Act, the judge must not only be expert in bankruptcy matters, but also must be a generalist of abilities equal to those of any federal judge. It does not make sense to create such extensive jurisdiction over matters relating to bankruptcy and vest it in a restricted "second-class" Article III judiciary, paid less than regular Article III district court judges.

Bankruptcy matters could be effectively handled by the creation of a relatively small number of additional district court judgeships under this proposal, because it would, in addition, establish a corps of strong bankruptcy administrators. An administrator would be appointed in each district, or group of districts, to manage and supervise all bankruptcy estates and litigation. The administrator's function would be to monitor and expedite the administration of each estate, and to bring contested matters promptly to the district court for resolution. The bankruptcy administrator would be authorized to approve uncontested matters to avoid unnecessarily burdening the district courts with such matters. This system should speed the resolution of bankruptcy cases and avoid the unnecessary expense of jurisdictional disputes. Because the bankruptcy administrator could not act on any disputed matters but must refer them to the district judge for resolution, questions concerning the allowable scope of his jurisdiction would be avoided entirely.

For these reasons, we urge that the Subcommittee give favorable consideration to this new proposal. I would note that we believe this proposal could be improved by the inclusion of provisions which would assure that contested bankruptcy matters are not denied a prompt resolution because of a backlog of civil or criminal cases. Though we believe that the courts, with the help of the proposed bankruptcy administrators, would be sensitive to the need for timely handling of bankruptcy matters, it would be appropriate to provide some statutory assurance. For instance, provisions might be included which give bankruptcy matters a priority over other matters on motion of a bankruptcy administrator or party. Another means of addressing this problem would be to require that the Chief Judge of each district appoint a bankruptcy "duty" judge at all times to hear bankruptcy motions and sign orders that require immediate attention. We would be pleased to work with the Subcommittee to develop such provisions.

B.

With respect to the earlier proposals to create bankruptcy divisions of the district courts or independent bankruptcy courts to adjudicate bankruptcy matters, my comments presented at the November 10 hearing are equally applicable here.

In summary, we prefer the approach reflected in H.R. 7294, which would create bankruptcy divisions as part of a unified federal district court. The 227 additional district judges would sit in the bankruptcy division principally to handle bankruptcy matters. To the extent that they were not required full-time to handle bankruptcy matters, the judges would be available for assignment to hear other cases in the district court or to sit on other courts by designation.

This approach would assure that bankruptcy matters will be handled promptly and expeditiously by Article III district judges familiar with bankruptcy law and serve to keep bankruptcy matters separate from the backlog of civil and criminal cases in the district court. At the same time, the approach would allow the efficient integration of the workload and judicial resources of the courts, under the general management of the chief judges of the district and the circuit, by allowing assignment of non-bankruptcy matters to bankruptcy division judges when this will not interfere with the expeditious handling of bankruptcy matters.

By contrast, the approach reflected in H.R. 6978 would create an independent trial court system to handle bankruptcy matters, exclusive of the district courts. As reported by the House Judiciary Committee, H.R. 6978 would, however, have facilitated the efficient use of bankruptcy judges at times when bankruptcy work had lessened by enabling bankruptcy judges to sit on district courts by designation. The great virtue of H.R. 6978 is that it recognized forthrightly that an Article III bankruptcy court solution was constitutionally compelled. Nevertheless, we prefer the "bankruptcy division" approach taken by H.R. 7294 to the creation of a new, wholly separate bankruptcy court as proposed by H.R. 6978 for several reasons. First, we believe that the creation of an entirely separate and new Article III bankruptcy court system with its own clerks and other officers is inefficient and unnecessary. More importantly, the segregation of bankruptcy judges into a separate court system together with salaries set at a lesser rate than district court judges would tend to lessen the prestige of the bankruptcy judgeships and make recruitment of the best candidates more difficult.

C.

In the present Congress, a bankruptcy court bill has been introduced as H.R. 3, which parallels H.R. 6978 with two major changes. The first of these changes in the prior bill we believe is unwise; the second would not, in our view, be responsible legislation.

In contrast to H.R. 6978, H.R. 3 would restrict bankruptcy judges to bankruptcy matters only, regardless of the relative caseloads of the bankruptcy courts and the district courts in each district. This restriction presents the very real risk of creating a large number of life-tenured judges who may find themselves with insufficient work to do as bankruptcy filings decline over time. This limitation would, moreover, tend to lessen the prestige of the judgeship and make recruitment of the highest quality candidates more difficult.

The second major change made by H.R. 3 to H.R. 6978 would provide that, instead of putting the new court system in place as soon as possible, the appointment of Article III judges would be staggered over a period of years. The new court system would not be finally in place until October 1985.

This provision of H.R. 3 is particularly questionable, because it would essentially attempt to reinstate and continue for 2½ more years a bankruptcy court system that the Supreme Court has expressly ruled unconstitutional. Although some delay in appointing judges is inevitable, other bills have set a far more reasonable target date of October 1, 1983. No one can sensibly contend that a 2½ year "transition" period for recruiting and appointing new judges is necessary. The reasons for this bloated "transition" period beyond the next presidential election appear to be wholly political and should not be allowed to obstruct the resolution of this important matter. There is a very serious risk that the Supreme Court will not tolerate the continuation of an unconstitutional bankruptcy court system during such an extended and politically-inspired "transition" period.

Those individuals and companies who, for whatever reason, find themselves in the bankruptcy courts should at least have the benefit of a workable and constitutionally sound court system, put in place as soon as possible. They should not be left in constitutional limbo for 2½ more years.

IV.

In conclusion, it is all too apparent that prompt legislative action is required to resolve the unfortunate crisis in which the bankruptcy system has been placed. Accordingly, I urge the Subcommittee promptly to develop legislation based on the model most recently proposed by the Judicial Conference.

The Administration is supporting a Judicial Conference proposal modified to include a bankruptcy priority because: (1) we recognize the need for an Article III judicial solution to our current bankruptcy crisis; and (2) this is the least costly, most flexible solution, which requires the addition of the fewest new judges to the federal bench. If the judicial manpower provided proves to be insufficient under this approach, a subsequent Congress can remedy the problem. We will not, however, be frozen into a large addition of judicial manpower which may not be needed in the future.

In conclusion, Mr. Chairman, the Administration wishes to be a constructive force in resolving this bankruptcy crisis. Throughout, we have tried to provide rapid progress toward the solution of this serious national problem. We hope that these hearings are a major step toward that common objective.

Mr. Chairman, that concludes my prepared statement. I would be pleased to answer any questions you or other members of the Subcommittee may have.

Senator Dole. Our next witness will be Spencer Williams, U.S. district judge, Northern District of California.

The record will indicate that Judge Williams is president of the Federal Judges Association.

STATEMENT OF HON. SPENCER M. WILLIAMS, U.S. DISTRICT JUDGE, NORTHERN DISTRICT OF CALIFORNIA

Judge Williams. My name is Spencer Williams. I am a U.S. district judge from the Northern District of California. I appear here today, as Senator Dole noted, as president of the newly formed Federal Judges Association, a self-supported group of article III circuit and district court judges numbering 280 at our last count, representing almost one-third of the active and senior article III judges.

We sincerely appreciate the opportunity to appear before you and express our views on this most important problem. The board of directors of the Federal Judges Association has voted unanimously to support the position of the Judicial Conference of the United States for an appropriate resolution of the problem arising from the Supreme Court decision in the *Marathon* case.

We appreciate the years and years that you have struggled with this problem trying to improve the administration of justice in this area. Too many years you have spent without work or help from the grassroots of the Federal judiciary. Many of us finally saw the problem and hopefully the light when the Supreme Court handed down *Marathon*.

Latecomers though we are, we urgently seek your disapproval of any solution that would authorize more than one article III court. Specifically, we believe that the establishment of an article III bankruptcy court would be counterproductive and regressive.

We fully recognize that the solution to this problem is totally within your discretion. The Congress has created inferior courts of the Federal system and has decreed its jurisdiction and can change that jurisdiction almost at will subject only to broad constitutional limitations.

All judges, however, are conscientiously committed to preserving and protecting a viable court system that is responsive to the needs of the Nation, and we believe that we have a duty to express our views to you, you who are the decisionmakers.

It is our view that we should continue the structure that has served this Nation so well since its earliest history, a unified judicial system whose judges become familiar with the full range of substantive law.

The creation of a separate article III bankruptcy court system would create needless confusion that would see too many judicial resources spent litigating questions of jurisdiction rather than solving the merits of the cases.

Furthermore, establishment of a specialized article III bankruptcy court could be the first step in fragmentation of the Federal judiciary. If a specialist article III court in bankruptcy, why not in admiralty, or taxes, or in crime, or in civil rights?

The trend has been in consolidating courts in this century. Those of my vintage recall from law school that we studied common-law pleadings and the judiciary then had separate courts for law, for equity, for crime and chancery and the like. Most of the cases we studied concerned whether or not the litigant was in the right court.

Are we to go back to that? Do we want specialized courts with their specialized bars and specialized bodies of law, discouraging general practitioners from participating and shutting out the full range and development of substantive law? I don't think so.

The Judicial Conference position recognizes two possible approaches. The first is called "congressional clarification or delineation of the jurisdiction of the bankruptcy court and the jurisdiction of the article III courts" and the second is the "restructuring of the system."

Should Congress adopt the first approach, we shall, of course, support it recognizing the inherent difficulty in drafting definitions that will be free from controversy and litigation.

Should Congress elect the restructuring alternative, we urge that jurisdiction over bankruptcy matters be vested in our general list article III judges. We can handle it and will handle it.

Handling bankruptcy will be no more difficult or onerous than some other recently added jurisdictional gems, such as OSHA, ERISA, NEPA, and others.

We believe the solution suggested by the Conference is a sensible, efficient way to handle the caseload, plus it answers most of the critics of the old system about divided authority or lack of responsiveness.

It should reduce controversy as to where jurisdiction lies. We appreciate having the chance to express our views on these matters as seen from our own perspective as judges. We know and accept that you must weigh issues other than form and structure in solving these difficult problems, and we hope that these other considerations can be accommodated without doing damage to a system that has served us so well these last 200 years.

Thank you. I will be happy to answer any questions.

Senator DOLE. Thank you.

Senator Heflin.

Senator HEFLIN. Have you seen the proposal of the Judicial Conference and studied it?

Judge WILLIAMS. No.

Senator HEFLIN. I agree with you. There was a statement in 1906 that dealt with the evils of many jurisdictions.

Federal judges themselves dealing with bankruptcy historically and almost universally have looked upon bankruptcy as a stepchild and they have placed it on back burners in the allocation of their wishes as to what type of cases they want to hear and have frequently postponed, and it has been very difficult.

That is one of the real faults that was testified about in the hearings prior to 1978 reform and when they had the one-forum concept that came about.

Now, what will the Federal judges themselves do relative to bankruptcy matters if it is not in a specialized court? Will they want to look at bankruptcy as being something that I want to avoid as the measles, and I am going to stay away from, or will the Federal judges realize it is a medium by which you can have specialized judges and not a specialized court, but specialized judges who would be required to devote a considerable amount of attention to prevent it from being a stepchild approach?

Judge **Williams**. We would not favor that. We have appointed the bankruptcy judge in my court also as the special master for admiralty matters, but I am watching that case and am participating in it.

I would say the judges would handle bankruptcy like any of the new jurisdictional matters you gave to them. We will give them special attention, as we know Congress felt they should be given special attention. I know Congress is moving against the idea of giving priority to certain cases, but we do have the Speedy Trial Act and we are following that diligently.

We do feel we could handle the bankruptcy matters initially and effectively, and we do think the administrator would be responsive. Sixty percent of the cases would be handled administratively and the administrator would have an obligation to see the other matters that are contested would be handled quickly by the magistrates or by the article III judges.

Senator **Heflin**. Under the rule fashioned by the Judicial Conference and now being adopted by various judicial councils to allow for the continuation which is basically consent and the right of a person to petition to have a final judgment entered by a district judge, as opposed to letting the present bankruptcy judges proceed in the event there is an agreement, he can proceed.

What defect do you see in that? Is it working? Are there shortcomings?

We have heard from the Department of Justice. It seems to me that upon further reflection that the period of time that has passed under the existing procedures and under the rule has been inadequate for anybody to make any valid judgment.

I mean, I can't see how the Department of Justice can come up with an opinion that it won't work in this period of time. What is your opinion?

Judge **Williams** We have no statistics. I have worked with judges who are working with it, and they say they are working fine. I have talked with Judge DeMascio in Detroit and a judge in Los Angeles. The system is working.

Senator **Heflin**. What defects are you seeing with it, and what advantages do you see in it?

Judge **Williams**. I don't see any jurisdictional defects. If they assign this to a bankruptcy judge and the litigants have the right to come back to the article III judge such as to a petition or appeal, then they could have article III consideration of their problems.

I think that meets the jurisdictional requirements and the defects which are pointed out in the *Marathon* case.

Senator **Heflin**. Obviously it would mean an increase in the workload of the district court judges. How much of an increase would it be? I think the period is so short that it is impossible to evaluate, but foreseen from your position as a Federal judge, how much workload problem is being created by the present procedure followed under this rule?

Judge **Williams**. I have not noticed any increase in the workload because it is new and we have not had a chance to look at it objectively.

I understand the Administrative Office believes it would require 114 article III judges above the number in the omnibus bill to handle the increased workload. I don't know how hard these figures are, but it would take time to be more precise.

Senator **Heflin**. When did the rule go into effect?

Judge **Williams**. I think it went into effect on December 24.

Senator **Heflin**. And the Department of Justice has given us an evaluation from the date of December 24 to the present time. Is there any way that you could through your association—and I know you have a very able lobbyist, Herb Hoffman, who is a fine man—is there any way at all that you could give us some sort of idea from judges in the field as to their anticipated increase in workload?

Judge **Williams**. First, I would like to correct a misimpression. Herb Hoffman is not our lobbyist. He is our Washington coordinator.

Senator **Heflin**. I noticed he had not yet bought a $500 suit.

Judge **Williams**. But I could talk to members of our association and find out quickly if they have noticed any dramatic increase in the workload and any difficulties working under the rule. The ones I have talked to see no problem in the operation of the rule and have not discussed with me the workload situation as yet.

Senator **Heflin**. That is all.

Senator **Dole**. The only observation I have, I guess we have a record number of bankruptcies, a half million last year. You are not concerned about that additional workload, is that correct? [Laughter.]

There may be even more than that this year.

Judge **Williams**. We in the past have struggled with heavy caseloads and have survived and managed. We have increased the disposition of cases every year, and I think, statistics bear this out. We would appreciate help if the workload goes up, and Congress has traditionally given more help when the workload has increased.

We have no concern that Congress will not do that at least when they see the results of what has happened.

Senator **Dole**. I think we will see a sharp decrease here one of these days. We have a hangover of cases from the past several years that will decline as the economy improves.

But I think you made an excellent statement and we will be in touch with you and your coordinator if he wants to coordinate. Like "revenue enhancement," it sounds so much better.

Judge **Williams**. He is coordinating us.

Senator **Dole**. Thank you very much. We appreciate it.

Judge **Williams**. Thank you, sir.

[The prepared statement of Judge Williams follows:]

PREPARED STATEMENT OF SPENCER M. WILLIAMS

Mr. Chairman, Members of the Subcommittee, my name is Spencer Williams. I am a United States District Judge in the Northern District of California. My service in that office commenced in August of 1971, a year after Congress created the Commission on Bankruptcy Laws, and two years before that Commission filed the report which proposed creation of an Article I court to resolve bankruptcy law issues. In the last decade the consequences of that Report have been challenging -- and burdensome -- for both Congress and the courts. Both institutions have dealt with the consequences while trying to deal with other serious problems. The road has been a long and difficult one, and I hope we all reach the end of it soon.

I appear today as President of the Federal Judges' Association, a relatively new organization, which was only incorporated under the laws of Illinois on March 30, 1982. The Federal Judges' Association consists of 280 active and senior Article III judges who are serving the courts of the United States today. Our organizational constitution defines our purpose as that of encouraging "the highest quality of justice" for those individuals who require services from the courts in the United States. Given that fundamental purpose, one of the matters before this panel today -- how to respond through legislative action to the Supreme Court's decision in the *Northern Pipeline* case -- is a matter of vital concern to all members of the Association.

I do not believe a single member of the Association remained unaware of the Supreme Court's decision in the *Northern Pipeline* case for more than several days following its announcement last June. In the weeks since, Association members have carefully monitored not only the decision's consequences in their own courts, but also the consequences here on Capitol Hill.

First, I want to assure you that we support your efforts to respond to a widely perceived need for remedial legislation, and we commend you for the conscientious and extensive efforts you have already made. We are not, however, encouraging you to "rush to judgment". A rushed "compromise" at the end of the Ninety-fifth Congress created the problem now before you. We urge you to act with care because your actions this time around could all too easily have irreversible consequences.

Second, I want to assure you that members of the Association stand ready to provide whatever assistance we may be able to provide. We realize that you are trying to accommodate sensitive practical and political considerations. We believe those considerations can be accommodated without inflicting serious lasting damage only if the Federal judicial system which has served this nation well for almost 200 years is not dramatically and irreversibly altered.

Shortly after the Judicial Conference responded to Congressional requests -- and its statutory responsibilities -- by filing a report concerning *Northern Pipeline* and then-pending proposals for remedial Congressional action last September, the Association endorsed the views expressed by the Conference in its report. We believed the "jurisdictional clarification" remedy recommended by the Conference was a sensible -- and an immediately effective -- remedy.

In early December, when the Conference recommended a "restructuring" remedy in response to Senator Thurmond's personal request, the Association again endorsed the Conference's recommendation. If a "restructuring" is deemed necessary by Congress, a full "merger" into district court jurisdiction makes good sense.

On behalf of the Association, I am here today to strongly recommend your favorable consideration of *either* of the Conference's recommendations. The multiple opinions filed in *Northern Pipeline* may disagree on many points -- but the *holding* in the case *at the very least* calls upon Congress to either (1) clarify jurisdiction or (2) restructure the judicial machinery for resolving cases "related to" bankruptcy law. If you accept a "jurisdictional delineation" remedy, the Conference's September 10 proposal is, I believe, the only one that has been offered. If you genuinely believe a "restructuring" remedy is essential, because authority to resolve all issues which may arise in the course of a bankruptcy case's resolution must be vested in one "tribunal", then the

Conference's December 1 proposal is the least disruptive and least expensive of the options available -- and it will not constitute a course of action which, if erroneous, can only be corrected with extreme difficulty.

The Association joins the Conference in strongly urging that you *not* fashion *any* remedial legislation which would statutorily authorize independent parallel courts of general jurisdiction under Article III of the Constitution -- regardless of the form, or "label", which such independent courts might be given -- only to handle bankruptcy proceedings. We do so because we believe that course of action will result in the dissolution of the generalist Article III Federal *trial* court system, which has proven its ability to adapt to dramatic demands for performance time and time again. Furthermore, if that approach proves in time to be a "quick fix solution" to a relatively temporary problem, we are all going to be struggling with the problem of "doing something" with *specialized* judges who hold their offices for life.

Let me emphasize that the Association evaluates this issue from a very basic premise. The service rendered by the district courts of the United States since 1789 has been widely acknowledged to be the foundation of an efficient and effective *Federal* judicial structure. As a district court judge, I will admit that our district courts do not always perform all functions *perfectly*; yet I am convinced that they are the most essential element in the most effective judicial system serving a free society in the world today.

I also emphasize the fact that the Association's views are in full agreement with the Conference's explanation of its "systemic context" for evaluating restructuring proposals, as presented in the September 10 Report to Congress. We agree fully with both the American Bar Association and the Conference that one *unified trial court* is absolutely essential to the preservation of our American *Federal* judicial system. Let me stress a point clearly: while specialization may have a place in many *State trial court* systems and even, in rare instances, in the Federal appellate area or the administrative law area, we believe it should remain as much an "exception to the rule" in our *Federal trial court* system in the future as it has been in the past. We fully concur in the American Bar Association's observation in its Standards Relating to Court Organization that: "specialization should be achieved within *the framework of* a *single* trial court". In other words, advantages in *administering* workloads *below* the trial judge level should be grasped, but *specialized judges* at the district level should not be created -- especially as an expedient answer of the moment for *any* class of cases which may be a problem at a given point in time.

I would note that the Senate endorsed that basic concept in developing its bill in the 95th Congress, from which the legislation which finally authorized the "specialized" Article I bankruptcy courts now in existence ultimately evolved through compromise. In general, I think it is fair to say that we are here today because the efforts in late 1978 to compromise the principle -- although they were good faith efforts to accommodate influential interests -- created an entity which tried to be *both* a "specialized trial court" and a "general jurisdiction trial court" at the same time. We have learned that that simply cannot be done. At the risk of appearing simplistic, I suggest that the answer today is no different from the answer six years ago: preserve a single general jurisdiction trial tribunal, but design an *administrative structure* which facilitates expeditious resolution of issues in dispute.

In the final months of the last Congress, as I understand the events, proposals ranged from the Conference's September 10 recommendation of a simple jurisdictional delineation, with no consequential restructuring, to the House Judiciary Committee reported proposal, which would have created a nationwide system of independent Article III bankruptcy courts. As I read *Northern Pipeline*, those two proposals -- at what might be termed opposite ends of a spectrum -- exemplify the two "extreme" options available to Congress for redrawing jurisdiction or restructuring the bankruptcy courts. As I previously noted, the Federal Judges' Association, at a point in time when *only* those two alternatives were under consideration, endorsed the Conference's jurisdictional delineation remedy.

As I understand events, proposals falling between the two extremes were offered by Members of this Senate Judiciary Committee, Congressman Butler, the Department of Justice, and the Judicial Conference during the "post-election" session. I believe it fair to characterize those proposals as of two general types: those which would (1) establish statutorily an "Article III division" in the district courts, devoted either *exclusively* to bankruptcy work or *primarily* to bankruptcy work, and (2) the Conference's proposal for merging bankruptcy work into the existing district courts' jurisdiction. The Federal Judges' Association believes that the "merger proposal" is a workable, sensible, and more-than-adequate remedy to the Supreme Court's ruling in *Northern Pipeline.*

I have reviewed the Conference's submission to Senator Thurmond of December 1, 1982. I have been briefed on its current status by the Administrative Office. I understand that documents required for a formal submission to Congress will be completed this week, after minor revisions are made following consultation with staff attorneys in Congress and in the Department of Justice. I doubt those revisions will alter the essential nature of the proposal.

As I understand the basic concept, creation of a Bankruptcy Administrator's Office in each judicial district, fully authorized to handle all *uncontested* matters in bankruptcy -- which realistically will consist *primarily* of Chapter 7 no-asset cases -- will in many districts relieve *judicial* personnel of the work associated with as much as, or more than, fifty percent of the *caseload.* District court judges, with the same assistance they now receive from magistrates in relation to all other civil cases, will be responsible for all *contested* proceedings in bankruptcy. Thus, only Article III judges will ultimately resolve litigated issues, unless parties consent to definitive resolution by a magistrate.

I personally believe that many practitioners will avail themselves of access to magistrates when doing so will serve their clients best interests. Most clients want expeditious decisions and a responsive judicial system more than prolonged litigation -- whether the issue is: "does jurisdiction exist?" or "should you exercise your authority?"

Before 1979 lawyers argued the first question before bankruptcy judges, and since 1979 they have most often argued the second. Both clients paying bills and lawyers billing clients, I suspect, want to minimize the time devoted to either type of argument.

In my review of the Conference's "merger proposal", I am impressed by the promise of flexible and expeditious responses to litigants' needs. In reviewing testimony previously provided Congress, I have been impressed by the extent to which the business community has emphasized its need for rapid access to judicial officers who hold authority necessary to provide a legally valid ruling. I think the merger proposal meets that concern without entailing any risk of the dangers associated with a "specialized tribunal" authorized to exercise general jurisdiction.

In addition to those "litigant service" factors which I have mentioned, I also believe that the economic aspects of a remedy must be a special matter of concern to *this* Congress. The "merger proposal" is unquestionably less expensive than any other restructuring proposal. Every judgeship created carries a large "price tag". You can play with judicial salary figures endlessly without real savings -- because the real expense is in institutional support for judges, not their pay. Why have three-hundred judges doing work when less expensive ways to do it are available?

Today the cost factors must be given great weight. As a district court judge, in service now for more than a decade, I am very much aware of the "appropriations crunch" which all Government units face. Time and time again in recent years, amounts appropriated for the Judicial Branch of Government have of necessity been reprogrammed and reallocated. In recent weeks you have heard many comments concerning the measure of "uncertainty" associated with the practice of bankruptcy law. Let me assure you that there is another element of uncertainty impacting Federal courts across the country -- which has been present not for a month but for several years -- and promises to be of increasingly grave concern in the future. Pressures upon the judiciary which have spawned the growth of supporting staffs and overall growth in the size of the system have been unremitting. Available appropriations have not kept pace. As a consequence, sensible planning for adjustment to growth has been extremely difficult. We deal with "uncertainty" on a daily basis on such matters as space and facilities, supporting personnel salary rates, and the numbers of deputy clerks necessary to keep pace with work in *both* the district *and* bankruptcy courts. The Conference's Report in September explained some of the problems we have faced since 1979, but not all of them. In short, the courts across the country are struggling to do more work with fewer resources and less money -- just as you are here in Washington. If you choose a "restructuring" remedy, you should choose the one that will minimize increased appropriations and take full advantage of existing personnel and physical resources. One aspect of the Conference's merger proposal which I find attractive is the extent to which existing personnel and facilities can be utilized with a minimum of growth -- and disruption -- in the existing court system.

I would like to note one additional feature of the Conference's restructuring proposal which I believe is of immense value. By merging jurisdiction and adopting the Conference's recommendation that any *transition period* arrangements be modeled upon a *statutorily authorized* jurisdictional delineation, I believe Congress may be able to obviate serious potential Constitutional questions. All other "restructuring" proposals that I have reviewed would require the Supreme Court to "wink at" the exercise of Article III authority by "carry over" Article I judges until newly authorized Article III judges enter on duty. Why take that chance when *existing* Article III judges can do what needs to be done *during* the "transition period"? Perhaps there will be some delay in some cases; better that than repeated challenges of unconstitutionality.

In addition, as I understand the Conference's "merger proposal", a district court, upon certification of its preparedness for merger, and approval of its circuit council, will be able to terminate reliance upon the jurisdictional delineation arrangement. I personally believe that permitting each court to assume full responsibility for the new structure as soon as it is able to do so makes far more sense than trying to arbitrarily designate a single date -- or several "staggered" dates -- upon which a restructuring will become effective nationwide. Why compel a majority of courts to postpone "restructuring" until the single court which will require the most time has become ready for it?

In closing, I would like to address two points which I believe Judicial Conference witnesses in recent years have been reluctant to address. First, I represent more than 200 district court judges, and I assure you we are not reluctant to handle bankruptcy cases which in fact require a judge's attention. I assure you we can handle them expeditiously. We routinely now handle a broad spectrum of matters in need of expeditious resolution satisfactorily. I draw cases which are less "fun" than others. I have a duty to hear them and I do. You work on legislation which is less "fun" than other legislation -- I suspect you find this matter tedious -- yet you do it because you have a duty to do it. I am here to tell you that district judges will do their duty.

Second -- and I believe this is related to what I have just said -- allegations which I have seen in print attributing disapproval of independent Article III bankruptcy courts to nothing more than the egocentricity of existing Article III judges are unwarranted and unfair. I know that on occasion several individual district judges have thoughtlessly made comments expressing resentment against bankruptcy judges who seek to "elevate" themselves to a higher status. I have personally heard such remarks. They were not well-reasoned, any more than they were tactful. How many of us have never spoken without thinking first? Even Senators have been known to do so. More importantly, I genuinely do not believe such *generalized* sentiments are held by very many Article III judges, if any. There may well be incumbents in bankruptcy judicial positions today who are not qualified to hold a district court position. That judgment, thank goodness, must be made by individuals who are not Federal judges. Ultimately, Senators decide such matters. Furthermore, there are individuals whose current performance in Article III judicial positions conclusively proves that bankruptcy judges can become competent Article III judges. One aspect of the allegations has mystified me for several years. To my knowledge no Congressional proposal in the past five years would have resulted in *incumbent* bankruptcy judges being automatically converted into Article III status. I assure you that most Federal judicial branch personnel at all levels have recognized that fact. The persistent repetition of the canard that we are "jealous" of our "status" is unjustified. We are concerned about the preservation of a unified Federal trial court at the district level. We oppose the establishment of separate specialized Article III trial units for such work -- regardless of their label -- because we genuinely believe that preservation of a single general jurisdiction court at the Federal judicial district level makes organizational sense, maximizes available resources, minimizes organizational confusion and case law conflict, and preserves the essential foundation of a judicial system which has proven its value -- and its ability to adjust to changing conditions -- for a period of almost two centuries. We believe the Conference has provided excellent draft bills for either course of action you believe you must take -- jurisdictional clarification or court restructuring.

All members of the Federal Judges' Association thank you for this opportunity to present these views.

Senator DOLE. We have next a panel of Hon. Richard L. Merrick, U.S. bankruptcy judge, Northern District of Illinois, and Ed Creel, of Creel & Atwood, P.C.

STATEMENTS OF HON. RICHARD L. MERRICK, U.S. BANKRUPTCY JUDGE, NORTHERN DISTRICT OF ILLINOIS, AND ED CREEL, OF CREEL & ATWOOD, P.C.

Judge MERRICK. Senator Dole and Senator Heflin, I am Richard Merrick, and I am going to follow your suggestion and not read my remarks.

Senator DOLE. I have read them. They are very good.

Judge MERRICK. First, let me address myself to some of the statements made by Mr. Rose, both orally and in his prepared statement.

He says that the current rule under which we are operating is unworkable, and I agree with him. As a practical matter, Monday, December 27, was the first day that anything happened. The lawyers were not in court very much that week and also the first week after the first of the year, so that there have only been about 2 weeks in which they have been seriously addressing this problem.

They are raising objections, they are raising questions about jurisdiction. On their pleadings the opponents have 25 days to answer. If these matters are being briefed, usually it is 20 days, 20 days and 10 days, so that at the moment the questions are really not in a position to be decided and the problems are not clear.

I have submitted a letter which three of the law professors, who are considered among the outstanding professors in this field in the country, sent to you and Senator Thurmond and Congressman Rodino last year in which they suggest not the bankruptcy court nor the district court nor any other court has jurisdiction over bankruptcy matters.

This is a very serious problem. One of the problems that we are going to have in dealing with issues of jurisdiction is who is to take an appeal? This rule is a rule of the district court.

Normally, the court does not decide on the validity of its own order. The district court operated under a directive from the circuit council. Ordinarily, as I say, a court does not review its own order, so that neither the district court nor the court of appeals would review a decision of the bankruptcy court, whether the rule is valid or is invalid.

How would the matter get to the Supreme Court? I do not know.

I think this is a situation where there are limited options. As Judge Klein said when he testified here several weeks ago, he thinks the choice is about as difficult as the choice was on December 8, 1941, whether we should mobilize. I think there is only one answer, that there has to be—and fairly soon—an article III court that is set up to handle bankruptcy matters.

One of the suggestions of Judge Williams is that the district court judges can handle this problem. In this hearing room in 1977, I believe, there were 15 judges of the Judicial Conference who were asked how much of their time they spent on bankruptcy work, and they estimated 3 percent. They are going to have to become instant experts if they are going to handle bankruptcy.

District Court Judge Cyr of the District of Maine has suggested that it takes 6 years for a bankruptcy judge to become sufficiently experienced so that he can handle difficult bankruptcy problems.

One of the things that was interesting in Mr. Rose's prepared statement is that he says he finds with respect to the automatic stay of section 362 of the Bankruptcy Code that many persons are contending that the stay is not effective because the bankruptcy court doesn't have jurisdiction to enforce it.

I find just the opposite in my court and in Chicago. Most of the lawyers say that the stay is effective, but that the bankruptcy court does not have jurisdiction to modify the stay.

I have found recently that what many bankruptcy judges are doing is not issuing discharges at all, because they do not want to delude the debtors into believing that they have a valid discharge, and I have not really decided how I am going to address that problem now. I have concentrated mostly on the problems that are created in the chapter 11 reorganization from the absence of clear jurisdiction.

Possibly the way to handle this is to give the discharge to the debtor, but tell him it may not be valid, suggest to him possibly that he have the district court judge certify it.

The safest thing, probably, to do is just to let the case pend. This would be my view, which is contrary to what Mr. Rose says, but my view is that if the case pends indefinitely under section 362 of the code the stay is in effect and nobody can do anything about the debtor. No problems get solved except he just is not subjected to pressure.

Mr. Rose criticized several aspects of the H.R. 3. One is the staggering proposal where the judges are to be appointed over a period of years. I have understood that that is a political matter, that there are some Democrats who do not want the Republicans to have all the appointments. Whether that is true or not, I don't know.

Senator DOLE. I can believe that would be a factor. [Laughter.]

Judge MERRICK. But that is the reason there is a staggering proposal in H.R. 3, and that is the reason it is in our bill.

I mentioned a prepared statement. I would hope, Senator Dole, that you would sponsor our bill. We would be delighted if Senator Heflin, Senator Metzenbaum, or any of the other Senators would join in the cosponsorship. This would be a way to get things started. It is a clean-cut bill similar to H.R. 3.

It has a couple of things in there that tighten up the appointment process so that there will not be questions about gaps and which judge is being removed and which judge is being reappointed. But other than that, it is essentially the same as H.R. 3.

Much of this that you are hearing is rhetoric or semantics, whether you have bankruptcy court judges or district court judges or district judges with magistrates or with magistrates and administrators as the Judicial Conference proposed in December, it is pretty much like a football team. It is the same team whether they are wearing the home uniform or the visiting team uniform and the expenses will be more or less the same if you have personnel in there with just about the same salaries.

Mr. Rose suggested you will not get as qualified persons if our salaries are lower than the district judges. We have no objection to being raised to their level. This was a proposal of H.R. 3 which we adopted.

Judge Williams suggested that he has not heard district court judges who were opposed to having bankruptcy judges become article III judges.

I attended a meeting of the Chicago Bar Association Committee on Bankruptcies and Reorganization last October, at which Chief Judge McGarr of the Northern District of Illinois spoke. He said that he is opposed to it, and he said he had three reasons for it.

Ten percent of the reason is that it expands the group, and there has been a small group of them and they have gotten to know each other, and it just is not as much fun getting together with the new people.

Senator DOLE. I have the same problem.

Judge MERRICK. And the second problem is that they do not have the same common interests, and at seminars and at cocktail parties they are not discussing the same problems.

But he said 75 percent of his reason is that the bankruptcy judges have not been selected by the same process as the district court judges. That may have been true in the past. It has no application in the future.

Now last year, for example, at the circuit dance, the bankruptcy judges weren't invited to the dance. They and their wives were not invited to the dance. The year before they were invited to dance, but the district court judges would not dance with the bankruptcy judges' wives.

Senator **Dole**. That may be the key to the whole thing. I think you are getting close.

Judge **Merrick**. I see that the red light is on—or the yellow light.

One thing about specialization of courts: In the last few years we have had a number of specialized courts created and I don't think it has caused any particular harm. There is a Tax Court and a Court of Claims and several others.

Just last year they set up the Court of Appeals for the Federal Circuit. There is a lot of discussion about having a special court for patents. Patents have become so complicated, the technology is so advanced, and whether computer programs are patentable. Those are things that a lot of people suggest experts should handle.

The trend in both this country and in Europe for the last half century has been toward specialized courts. The bankruptcy court, in effect, has been a separate court for 44 years. It is just a matter of semantics that it was not an article III court.

I think that does conclude my remarks. I would be glad to answer any questions you might have.

Senator **Dole**. I think, first, we might want to hear from Mr. Creel. I think you raised a point that it is a matter of prestige, and I think there might be some opposition to the article III courts because of that. I am not suggesting that that is an overriding reason, but it bears out what you have just indicated.

Mr. Creel.

Mr. **Creel**. Good morning. I am glad to be back, and I hope I can be helpful. I am here, first, as a practicing bankruptcy lawyer, which I have been for 15 years or so, and, second, as the president of the newly formed American Bankruptcy Institute.

On January 7, 1983, in this building a forum was held in conjunction with Senator DeConcini and former Congressman Butler, who, with the assistance of the ABI, invited 100 people from across the country to come to Washington and to voice their views with respect to the Marathon problem.

We had in attendance bankers, lawyers, judges of all levels, businessmen, insurance people, all to discuss the Marathon problem. The consensus of that meeting was threefold: First, there was a serious problem. In the record of that proceeding there are numerous examples.

I would like to make that record a part of this record, if I may.

Senator **Dole**. That will not be printed, but it will be put in the committee files.

Mr. **Creel**. The second conclusion reached was that the "emergency rule" promulgated by the Judicial Conference that went into effect on December 25 was not effective, basically for three reasons:

First, there was a substantial legal question as to the authority of the Judicial Conference to promulgate the rule in the first place.

Second, assuming the authority to promulgate the rule, there was a serious question as to its constitutionality.

Third, the practical reason that because of the language of the rule itself it was intrinsically unworkable.

The third conclusion that was reached at that forum was, as has been expressed this morning, that because we have a problem, because we have an unworkable stopgap rule, it is necessary for Congress to move promptly. I believe the consensus of that group also was that the solution to the problem was, as has been previously expressed, article III judges.

That is the essence of my prepared remarks for the record. Additionally, I would like to make a couple of comments.

Senator DOLE. Let me say that the entire remarks have been made part of the record, along with Judge Merrick's.

Mr. CREEL. Thank you.

As Senator Metzenbaum mentioned when we started, I do think it is incumbent upon the Congress to keep the issues as simple as it can, work on the constitutional/jurisdictional problem and leave the other issues to be resolved by debate and conference at some future time.

Let me mention to you a case that happened in our district last week as represented to me by one of our judges, to give you an example of the problem we are having with the hiatus now. That judge, incidentally, mentioned to me that he is spending more than half his time on jurisdictional issues now instead of merit. Nothing further need be said about that.

The case involved a subsidiary corporation of a large conglomerate parent. The subsidiary was in chapter 11 and owned a big piece of real estate. The parent was also teetering financially.

The subsidiary was fortunate enough to find a buyer for the property that would produce enough money to bail out the subsidiary from its chapter 11 proceeding and also to ease the cash flow problems of the parent.

The order was issued, the parties went down to the title company to close the sale—in Texas we have title companies that approve sales. The title company said:

> Wait a minute. We need a Federal district judge's signature on the order and we want all the secured parties on the order because we are not sure the Federal district court has jurisdiction in bankruptcy, and we want the right to procure the signatures on the deed of all of the unsecured creditors.

That was ridiculous. The sale blew and the companies folded. I would like to comment briefly on Mr. Rose's comments, which I first heard a few moments ago. It sounds to me like the bankruptcy administrator suggestion that he mentioned is the same sort of thing that we have with a referee or magistrate or any other kind of nonjudicial person.

I am not sure that aids the problem. I think it confuses it, and we are trying to get away from that.

Second, I have serious constitutional problems with any kind of consensual jurisdiction. We have consensual jurisdiction in this "Emergency Rule." Mr. Rose's comments suggest consensual consent for relatively routine matters to be administered by the person he suggested.

I do not believe that will do anything but make the problem more serious.

He suggested that contested issues be relegated to the district court. To put disputed procedures in context, let me say this: I am a lawyer, I go into pretrial and the other lawyer goes, and we visit before the case is to be heard. The way things were before December 24, assuming the bankruptcy court had jurisdiction, we knew the court had jurisdiction. We did not discuss that.

We discussed the merits of the debate between us. We got right to the heart of the problem because we knew we were in a forum where the forum could decide.

Once you introduce any kind of a crack, any kind of a question into the jurisdictional power of whatever kind of officer the lawyers are before, I assure you that the one with the weakest case is going to holler "jurisdiction" and he is going to argue about that and use the delay that that creates as a lever to put money in his client's pocket.

Delay is the "name of the game." Any time in an argued context, one party has the power to utilize delay, it is going to be used.

Similarly, in the de novo trial business, which promotes the same sort of thing: Delay, the losing party is always going to appeal the issue because he knows he can start over again and have two bites at the apple.

I think we must understand that you cannot say we are going to neatly put into one category contested matters and neatly put into the other category uncontested matters, because that is not the way it is in the real world. All matters are going to be contested if there is a choice.

I think that the bottom line is: What is really being asked for as a solution to the problem. As I mentioned earlier, the consensus of the earlier forum seems to be broad article III jurisdiction. That really breaks down into four areas of problems.

One is salary and expense. I suggest to you, gentlemen, that there is going to be no more cost to making bankruptcy judges article III judges than they currently cost. If anything, there will be less cost than if a bunch of Federal district judges are named, because the full panoply that goes with the district judge level need not apply to the bankruptcy judge.

Salaries can be controlled by Congress once. They just cannot be lowered later. The trappings new bankruptcy judges get can be controlled by Congress and that should not be a problem.

The number of judges, which is the second category, can also be fixed by Congress. You figured out a way to do that in the transition section of the current code, pick the same number of bankruptcy judges that were going to be picked anyhow. There will not be a larger number of bankruptcy judges needed than there were in 1978 when the bill was passed in the first place.

The third thing is tenure. The code now gives them 14 years. Another few years should not make any difference. I do not think if a study were done, the facts would show that a bankruptcy judge sits on the average of 14 years anyhow, and I suggest that maybe one fact that might be helpful to the Congress is a study of the average tenure of a bankruptcy judge based on the years of experience that we have.

I think we will find that 14 years as now promulgated is plenty of time, so lifetime tenure is not going to add anything that does not already exist, as a practical matter.

Finally is the issue of the breadth of jurisdiction. That is the issue you have the most difficulty with. I sympathize with the problem that bankruptcy judges may have too much or not enough jurisdiction.

I suggest to you that if judicial economy is the keynote, as Senator Heflin has suggested, cases can be more expeditiously and more cheaply tried if everything related to a complex case is brought into the one court and all the issues in a simple case are there in the first place.

Thank you.

Senator DOLE. Senator Heflin.

Senator HEFLIN. Judge Merrick, do you foresee any constitutional problem creating an inferior article III judge?

Judge MERRICK. I don't see that that presents any problem. I think you can have article III courts of all sizes and shapes as long as there is life tenure and the salary cannot be reduced during the term of office.

Senator HEFLIN. It never has been decided, and as far as you can see, you see no impediment toward that?

Judge MERRICK. I don't see any reason for it. The whole reason for the rule is that the King or the Colonial Governor used to remove colonial judges from office or suspend their salaries or reduce their salaries if they didn't like their decisions.

So that is the basis for the constitutional requirement.

Senator HEFLIN. Is there any problem under the concept of equal access to justice? You relegate bankruptcy decisions relative to equal access to justice, you relegate an inferior type of judge—I don't know. I am interested in any comments you might have.

Judge MERRICK. Well, this "inferior," it is an inferior court. The judges do not need to be inferior. What is happening for me on a regular basis when the question of jurisdiction comes up and there is a suggestion that maybe the lawyers should take the case to the district court, they say, "Judge, we don't want to go to the district court. We want to have it heard by you. We want to have somebody decide the problem who understands the law."

I have had lawyers offer to indemnify me for any personal liability I might have for deciding a case without jurisdiction. This presents all kinds of problems under section 455 of the Judicial Code.

If we have a personal interest in a case because of potential personal liability, it presents all kinds of problems also under Canon 3 of the Code of Judicial Conduct, whether we should hear a case in which we have a personal interest because of potential liability.

There is just a myriad of problems, but I think that there might be a certain amount of judicial shopping. If the lawyers have a choice between the district court and the bankruptcy court, I am sure that 99.44 percent of them would go to the bankruptcy court.

Senator HEFLIN. Costwise, between your proposal and the proposal of the Judicial Conference and the Department of Justice, and nobody has yet put a pencil to paper and figured it up, but you would have under Rodino's H.R. 3, which you advocate—you would have 227 judgeships and 115 now, depending on how many magistrates and other things are involved.

But I can foresee actually the proposal would be more expensive than the Judicial Conference. Do you think it will or will not be?

Judge MERRICK. I think it will not. At the present time in Chicago, for example, and this is pretty much true around the country, the district court judges have two-story courtrooms. Their courtrooms contain about 6,000 square feet. Ours contain about 600.

I think if you had district court judges appointed, the district court judges would say, "I want to have a two-story courtroom like everybody else. I want to have two law clerks like everybody else. I want to have a great big courtroom just like everybody else."

If the bankruptcy judges do the job, or if you have an article III bankruptcy court, there is no particular reason you can not have the same-size courtrooms that you have now, the same-size chambers. Ours are probably a quarter of the size of theirs. We have one law clerk, they have two.

There is no reason that the expense needs to go up very much, and these studies that were prepared by the Administrative Office, one of them showed a $48 million increase and another a $56 million increase. This was on the assumption that we would all get great big courtrooms.

There is no reason for that at all.

Article III doesn't require we have big courtrooms and it does not make any difference to us whether we have the same size courtroom as somebody else or not.

Senator **Heflin**. We had better start figuring, though. If we go toward the other one, we may have to build a few more courthouses.

Let me ask you about a practical problem under the existing law: In April 1984, I believe it is, all the bankruptcy judges will be subject to reappointment. If you made all bankruptcy judges article III judges, and they have to be appointed by the President and go through the confirmation process, involved with that there is some history of how long it takes to go through the investigation by the FBI, the American Bar Association and other bar associations and for the Judicial Committee of the House. I have seen the figures and it may be a ball park figure, that it takes 425 days, which is more than a year.

The transitional problems under yours, in order to be able to have an orderly transition, do you foresee problems? Maybe our track record would improve here. Maybe the track record of the White House or the Department of Justice or the American Bar might improve, but assuming we are faced with 227 new article III judges to be appointed by the President, do you think that it would be necessary to postpone that date of April 1, which terminates the present bankruptcy judges, to a later date?

Judge **Merrick**. Well, you are asking me to do a little mindreading on what the Supreme Court will do.

In the *Zdanok* case it indicated—the Court indicated that it would go along for a period of time if the proper structure had been set up, and to let unconstitutional persons act for a period of time. Whether they would go on for 3 years or so, I have no idea.

The figure I have heard on the actual time it takes to process a judicial nominee, if there are no other delays, is 183 days. If everything is right on track, it takes 183 days on the average to get somebody in; so that is going to take time. It is not going to take any longer to clear a person for a 14-year appointment than it is for a lifetime appointment.

So you have the same problem there.

Senator HEFLIN. I think that is what I am doing. It seems to me whether you go with the 115 or 227, if the regular time frame is involved, then it appears to me that we may well have to approach this legislation from a temporary basis and a permanent basis, and it may well be that we would have to adopt, Mr. Creel, some type of thing that does not have all the jurisdictional problems that could arise.

I just foresee, after hearing your testimony and trying to think about this thing, that you have got a short-range problem and you have got a long-range problem, and I think we are going to have to address it from the short-range as well as a long-range problem either way we proceed.

Mr. CREEL. We talked about that last time I was here, and it seems to me it was April 1, 1984, more than 425 days away now perhaps, or close to it. If Congress is able to get to this problem quickly—and by that I mean within the next several months, if that is realistic—and if in setting up its timetable in the new legislation it moves that April 1, 1984, date up a few months and at the same time those investigators get started, by the time we get to transition date the problem could be at least substantially concluded.

They don't have to wait until April 1984 to get started.

Judge MERRICK. Senator, I was going to suggest another possibility. What could be done is to get one article III judge in place in each district where you have constitutional problems, assign those to him, and have the other judges do the routine jobs. They would not like that very much, but if we have a major constitutional problem or political problem, that is a possible solution.

Senator HEFLIN. I was interested in your observation, Judge Merrick, that it takes 6 years for the bankruptcy judge to become an expert. Under the single-forum concept, do you see a timelag problem before a bankruptcy judge or a judge becomes an expert in antitrust, in Securities and Exchange, in domestic relations, in civil rights, Equal Employment Opportunity Acts, airplane crashes and other matters?

Is bankruptcy more complicated than a Securities and Exchange case?

Judge MERRICK. I do not know that it is more complicated than some of those Securities and Exchange issues, particularly where you have an attempt by a citizen to collect on a prohibition that may have been designed for the Commission to act on.

I think bankruptcy is more complex than some of the other matters you mentioned, such as domestic relations. But this is—it may not be more difficult for the judge. It may be more difficult for the litigant.

Mr. CREEL. I may suggest on that, too, that it is different. All the issues that the Senator mentioned are issues from time to time in bankruptcy cases as far as the legal arguments are concerned. The bankruptcy judge probably hears them all just like the Federal district judge does.

It is the practical dollars-and-cents expeditious approach to complex problems, that is, the uniqueness that needs to be protected, and it is that uniqueness that is endangered by our present hiatus in the law.

A bankruptcy judge is tuned differently than a Federal district judge, not because he is more or less a scholar or hears more or less law. It is just that his perception of the complexities of the law are different than when you have two litigants on a single issue before a court.

Senator **Heflin**. Thank you.

Senator **Dole**. Thank you very much, again, for your expert statement, Judge Merrick and Mr. Creel. We will ask for more information. I know we had a staff member at your meeting, and it is good information, and we hope to use that.

I think from hearing all the testimony so far we need to move very quickly in Congress. It is not illegal to do something around here before March and, you know, we are going to be here all this week and we have a recess coming up, and we will have worked 3 or 4 days by then.

Judge **Merrick**. Senator, I do appreciate the opportunity of being here, and I want you to know if there is any way I can help in the future, answering any questions or preparing any statistics, I would be delighted to do it.

Senator **Dole**. Thank you.

[Material submitted by Judge Merrick and Mr. Creel follows:]

Exhibit to Accompany Testimony
of Judge Richard L. Merrick

EXPLANATION OF PROPOSED BILL

The bill we are offering today differs from the House bill, H.R. 3, in the following respects.

1. We have added one additional judgeship position in the Northern District of Texas and the Western District of Wisconsin to reflect the fact that part-time positions in those districts have been converted to full-time positions due to the volume of the workload.

2. We have inserted proposed new retirement provisions for incumbent bankruptcy judges who are not reappointed. These provisions are adapted from a statutory proposal to govern "Retirement of Fixed Term Judicial Officers" submitted to Congress by the Judicial Conference of the United States on December 1, 1982. Once in place, this system can be expanded to cover judges of the Court of Claims, magistrates and judges of the Court of Military Appeals, whenever Congress deems such expansion appropriate.

3. We have added to Section 51 of the House bill two provisions relating to the staggering of appointments of Article III bankruptcy judges. In Section 51(b)(1) we add a new Subparagraph (C) which provides that in a multi-judge district incumbent bankruptcy judges shall be replaced in the order of entry on duty. Without such a provision the statute is unclear as to which judge is being replaced in a multi-judge district. We are also adding a new Paragraph (3) to Section 51(a) of the bill, the effect of which is to encourage the President to reappoint qualified incumbent judges. The new paragraph provides that the limitations on the number of appointments authorized for 1983 and 1984 shall not apply to the reappointment of incumbent judges.

We are concerned that in a multi-judge district all the incumbent judges may be pitted against each other in seeking appointment to the initial vacancy. If an incumbent judge other than the occupant of the first office deemed vacant is appointed to fill such vacancy, the district will be one judge short during the remainder of the transition period, because Section 51(b)(2) precludes appointment to fill a vacancy occurring for a reason other than death or retirement.

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OFFICER

April 21, 1982

Mr. Francis C. Rosenberger
6809 Melrose Drive
McLean, Virginia 22101

Dear Francis:

Please express my personal apologies to Judge Gandy for not being able to provide an actual draft text of proposed legislation to achieve those recommendations approved by the Judicial Conference at its March Proceedings relating to a new retirement program for bankruptcy judges. Although a summary of the elements which will be contained in our draft proposal upon its completion is, I realize, not as valuable to you, I provide it for whatever value it may have. In the final analysis, the draft proposal language is, I believe, a secondary concern. I assure you that my office is as committed to resolving the issue as it is possible to be.

At its March Proceedings, upon recommendation of its Court Administration Committee, the Conference both reaffirmed and clarified its policy statement of March 1980 (which had raised legitimate questions due to its ambiguity) and positively recommended a specific program for implementing that clarified policy determination. In policy terms, the Conference fully endorsed a tripartite retirement arrangement for judicial branch officers and employees. It recommended retention of the basic Article III retirement program presently authorized under 28 U.S.C. sections 371 and 372 for Article III judges, appropriate reforms in the existing Article I judicial branch officer retirement program authorized by 28 U.S.C. section 373 to insure that that program treats all judicial branch Article I judges equitably, and the continued availability of civil service retirement program participation for all other judicial officers and employees. As you know, the Conference also specifically approved elective participation by full-time magistrates in a modified section 373 retirement program; in other words, permitting full-time magistrates to elect either participation in the civil service retirement program or participation in the Article I judicial officer program.

The Conference specifically recommended repeal of the existing provisions in section 373 of Title 28 and substitution, in lieu thereof, of provisions which would authorize:

1. Retirement creditability of years of service by Article I judicial officers, regardless of their terms of office, under section 373;
2. Entitlement to the full salary of office payable on the date of retirement if at least 14 full years of service have been completed;
3. Entitlement to a basic retirement annuity upon the completion of 8 years of service and to a basic disability annuity upon completion of 5 years of service;
4. In the case of a retirement annuity conferred for service of more than 8 but less than 14 years, the amount of the annuity would be calculated as that percentage of salary of office upon the date of retirement equivalent to the number of years of service rendered divided by 14;
5. In the case of a disability retirement conferred for years of service numbering more than 5 but less than 14, an annuity would be calculated as that percentage of that salary paid at the date of retirement equivalent to the ratio of years of service beyond 5 divided by 14;
6. Any period of service exceeding 6 months would be deemed equivalent to a full year; a period of service not equivalent to 6 months would not be creditable as a year of service;
7. Contributions by Article I judicial officers would not be required;
8. The new section 373 program will not be mandatory; any eligible officer will be permitted to elect that program at any time prior to filing a notice of retirement with the Director of the Administrative Office;
9. An officer electing participation in the civil service retirement program at commencement of service and subsequently electing retirement under section 373 would be entitled, by express provision, to a full refund of contributions to the civil service retirement program;
10. Upon election of participation in the 373 program, an officer will also be able to elect participation in the judicial survivors annuities program authorized by 28 U.S.C. section 376; and
11. The existing formula for providing "cost of living adjustments" in survivors annuities now contained in section 373 will be retained with only one modification; the existing "ceiling" of 95 percent of the salary of a district court judge in regular active service would be reduced to 85 percent.

Of special interest to you are those provisions which will expressly address the specific application of the new program to individuals serving as bankruptcy judges on March 31, 1984, who are subsequently appointed to Article I judicial positions and those who are not so appointed. The Conference expressly approved creditability of periods of service as a bankruptcy judge from October 1, 1979 as creditable under the 373 formula in all cases. It expressly disapproved creditability of all bankruptcy referee service prior to October 1, 1979 under the section 373 formula. Therefore, individuals appointed to Article I bankruptcy judge positions after April 1, 1984 will be able to credit what we have described as "transitional period service" in full measure with their Article I service. Individuals who are not so appointed will be able to elect an annuity under their existing authorized civil service retirement formula alone, or -- alternatively -- an annuity computed in a two-step process: (1) computation of an amount under the existing civil service formula for service up to October 1, 1979; plus (2) an amount computed by crediting transitional period service under the section 373 formula.

As you know, the Court Administration Committee expressly recommended that payment of an annuity under the reformed provisions of section 373 be expressly prohibited prior to attainment of age 55, but the Judicial Conference did not accept that recommendation and substituted age 65 for age 55. Because that factor may influence an individual's election between civil service retirement and section 373 retirement, I have been advised that the appropriate Congressional committees will examine it with care.

Finally, with the Presidential approval on April 2 of P.L. 97-164, if Judicial Conference-recommended amendments to 28 U.S.C. section 373 are enacted, they will be applicable to Article I judicial officers serving "territorial courts", U. S. bankruptcy courts, and the U. S. Claims Court.

Again, I apologize for not being able to provide at this time a draft of the proposed legislation. As you know, there are factors involved in assembling the bill as approved by the Conference which have nothing to do with amendments to section 373 of Title 28 as applicable to service rendered to the bankruptcy courts. The reconciliation of details related to those other elements of the bill have been somewhat time-consuming. As soon as the text has been completed, I will certainly forward the text to both you and Judge Gandy in precisely the format in which Mr. Foley transmits the material to Congress on behalf of the Judicial Conference.

Sincerely,

Bill Weller

William James Weller
Legislative Affairs Officer

Legislative Draft to Accompany
Testimony of Judge Richard L. Merrick

98TH CONGRESS
1ST SESSION

S.______

To provide for the appointment of United States bankruptcy judges under article III of the Constitution, and for other purposes.

IN THE SENATE OF THE UNITED STATES

A BILL

To provide for appointment of United States bankruptcy judges under article III of the Constitution, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Bankruptcy Court Act of 1983".

SEC. 2. (a) Title 28 of the United States Code is amended by inserting after chapter 5 the following new chapter:

"CHAPTER 6--BANKRUPTCY COURTS

"Sec.
"151. Creation and composition of bankruptcy courts.
"152. Appointment of bankruptcy judges.
"153. Tenure and residence of bankruptcy judges.
"154. Salaries of bankruptcy judges.
"155. Chief judge; precedence of bankruptcy judges.
"156. Division of business among bankruptcy judges.
"157. Times and places of holding court.
"158. Vacant judgeship as affecting proceedings.
"159. Appellate panels.

"§151. Creation and composition of bankruptcy courts

"(a) There shall be in each judicial district a bankruptcy court which shall be a court of record known as the United States Bankruptcy Court for the district.

"(b) Each bankruptcy court shall consist of the bankruptcy judge or judges for the district in regular active service. Justices or judges designated and assigned shall be competent to sit as judges of the bankruptcy court.

"(c) Except as otherwise provided by law, or rule, or order of court, the judicial power of a bankruptcy court with respect to any action, suit, or proceeding may be exercised by a single bankruptcy judge, who may preside alone and hold a regular or special session of court at the same time other sessions are held by other bankruptcy judges.

"§152. Appointment of bankruptcy judges

"The President shall appoint, by and with the advice and consent of the Senate, bankruptcy judges for the several judicial districts, as follows:

"Districts	Judges
Alabama:	
Northern	4
Middle	2
Southern	2
Alaska	1
Arizona	4
Arkansas:	
Eastern	1
Western	1
California:	
Northern	7
Eastern	4
Central	12
Southern	3
Colorado	4

Connecticut	2
Delaware	1
District of Columbia	1
Florida:	
Northern	1
Middle	2
Southern	3
Georgia:	
Northern	4
Middle	2
Southern	1
Hawaii	1
Idaho	1
Illinois:	
Northern	8
Central	2
Southern	1
Indiana:	
Northern	2
Southern	4
Iowa:	
Northern	1
Southern	1
Kansas	3
Kentucky:	
Eastern	1
Western	2
Louisiana:	
Eastern	2
Middle	1
Western	2
Maine	2
Maryland	2
Massachusetts	4
Michigan:	
Eastern	4
Western	2
Minnesota	4
Mississippi:	
Northern	1
Southern	2
Missouri:	
Eastern	3
Western	3
Montana	1
Nebraska	1
Nevada	2
New Hampshire	1
New Jersey	5
New Mexico	1

New York:	
Northern	2
Southern	7
Eastern	6
Western	3
North Carolina:	
Eastern	2
Western	1
Middle	2
North Dakota	1
Ohio:	
Northern	8
Southern	7
Oklahoma:	
Northern	1
Eastern	1
Western	2
Oregon	4
Pennsylvania:	
Eastern	3
Middle	2
Western	3
Puerto Rico	2
Rhode Island	1
South Carolina	1
South Dakota	1
Tennessee:	
Eastern	2
Middle	2
Western	2
Texas:	
Northern	4
Southern	3
Eastern	1
Western	2
Utah	2
Vermont	1
Virginia:	
Eastern	3
Western	2
Washington:	
Eastern	1
Western	4
West Virginia:	
Northern	1
Southern	1
Wisconsin:	
Eastern	3
Western	2
Wyoming	1

"§153. Tenure and residence of bankruptcy judges

"(a) The bankruptcy judges shall hold office during good behavior.

"(b) Each bankruptcy judge, other than a bankruptcy judge of the United States Bankruptcy Court for the District of Columbia, shall reside in the district or one of the districts for which he is appointed.

"(c) If the public interest and the nature of the business of a bankruptcy court require that a bankruptcy judge should maintain his abode at or near a particular place for holding court in the district or within a particular part of the district the judicial council of the circuit may so declare and may make an appropriate order. If the bankruptcy judges of such a district are unable to agree as to which of them shall maintain his abode at or near the place or within the area specified in such an order the judicial council of the circuit may decide which of them shall do so.

"§154. Salaries of bankruptcy judges

"Each bankruptcy judge shall receive a salary at an annual rate of $69,500, subject to adjustment under section 225 of the Federal Salary Act of 1967 (2 U.S.C. 351-361) and section 461 of this title.

"§155. Chief judges; precedence of bankruptcy judges

"(a)(1) In any district having more than one bankruptcy judge, the chief judge of the district shall be the bankruptcy judge in regular active service who is senior in commission of those judges who--

"(A) are sixty-four years of age or under;

"(B) have served for one year or more as a bankruptcy judge; and

"(C) have not served previously as chief judge.

"(2)(A) In any case in which no bankruptcy judge meets the qualifications of paragraph (1), the youngest bankruptcy judge in regular active service who is sixty-five years of age or over and who has served as bankruptcy judge for one year or more shall act as the chief judge.

"(B) In any case under subparagraph (A) in which there is no bankruptcy judge in regular active service who has served as a bankruptcy judge for one year or more, the bankruptcy judge in regular active service who is senior in commission and who has not served previously as chief judge shall act as the chief judge.

"(3)(A) Except as provided in subparagraph (C), the chief judge of the district appointed under paragraph (1) shall serve for a term of seven years and shall serve after expiration of such term until another judge is eligible under paragraph (1) to serve as chief judge of the district.

"(B) Except as provided in subparagraph (C), a bankruptcy judge acting as chief judge under subparagraph (A) or (B) of paragraph (2) shall serve until a judge has been appointed who meets the qualifications under paragraph (1).

"(C) No bankruptcy judge may serve or act as chief judge of the district after attaining the age of seventy years unless no other bankruptcy judge is qualified to serve as chief judge of the district under paragraph (1) or is qualified to act as chief judge under paragraph (2).

"(b)(1) The chief judge shall have precedence and preside at any sesion which he attends.

"(2) Other bankruptcy judges shall have precedence and preside according to the seniority of their commissions. Judges whose commissions bear the same date shall have precedence according to seniority in age.

"(c) A judge whose commission extends over more than one district shall be junior to all bankruptcy judges except in the district in which he resided at the time he entered upon the duties of his office.

"(d) If the chief judge desires to be relieved of his duties as chief judge while retaining his active status as bankruptcy judge, he may so certify to the Chief Justice of the United States, and thereafter, the chief judge of the district shall be such other bankruptcy judge who is qualified to serve or act as chief judge under subsection (a).

"(e) If a chief judge is temporarily unable to perform his duties as such, they shall be performed by the bankruptcy judge in active service, present in the district and able and qualified to act, who is next in precedence.

"§156. Division of business among bankruptcy judges

"(a) The business of a bankruptcy court having more than one judge shall be divided among the judges as provided by the rules and orders of the court.

"(b) The chief judge of the bankruptcy court shall be responsible for the observance of such rules and orders, and shall divide the business and assign the cases so far as such rules and orders do not otherwise prescribe.

"(c) If the bankruptcy judges in any district are unable to agree upon the adoption of rules or orders for that purpose the judicial council of the circuit shall make the necessary orders.

"§157. Times and places of holding court

"(a) The bankruptcy court at each designated place shall be deemed to be in continuous session on all business days throughout the year.

"(b) Each bankruptcy court may establish by local rule or order schedules of court sessions at designated places of holding court other than the headquarters office of the court. Such schedules may be pretermitted by order of the court.

"(c) Bankruptcy court may be held at any place within the district served, in any case, on order of the bankruptcy court, for the convenience of the parties, on such notice as the bankruptcy court orders.

"§158. Vacant judgeship as affecting proceedings

"When the office of a bankruptcy judge becomes vacant, all pending process, pleadings, and proceedings shall, when necessary, be continued by the clerk until a judge is appointed or designated to hold such court.

"§159. Appellate panels

"(a) If the circuit council of a circuit orders application of this section to a district within such circuit, the chief judge of the circuit shall designate panels of three bankruptcy judges to hear appeals from judgments, orders, and decrees of the bankruptcy court of the United States for such district. Except as provided in section 293(b) of this title, a panel shall be composed only of bankruptcy judges for districts located in the circuit in which the appeal arises. The chief judge shall designate a sufficient number of such panels so that appeals may be heard and disposed of expeditiously.

"(b) A panel designated under subsection (a) of this section may not hear an appeal from a judgment, order, or decree entered by a member of the panel.

"(c) When hearing an appeal, a panel designated under subsection (a) of this section shall sit at a place convenient to the parties to the appeal."

(b) The table of chapters of part I of title 28, United States Code, is amended by inserting after the item relating to chapter 5 of such title the following new item:

"6. Bankruptcy courts.................................. 151".

SEC. 3. Section 291(b) of title 28, United States Code, is amended by inserting "or bankruptcy" after "to hold a district".

SEC. 4. Section 292(b) of title 28, United States Code, is amended by inserting "or a bankruptcy court" after "to hold a district court".

SEC. 5. Section 292(d) of title 28, United States Code, is amended--

(1) by striking out "either",

(2) by inserting "bankruptcy court," after "in a", and

(3) by inserting a comma after "district court".

SEC. 6. (a) Section 293 of title 28, United States Code, is amended by adding at the end thereof the following new subsection:

"(b)(1) The Chief Justice of the United States may designate and assign temporarily a bankruptcy judge of one circuit for service in a bankruptcy court in another circuit upon presentation of a certificate of necessity by the chief judge or circuit justice of the circuit wherein the need arises.

"(2) The chief judge of a circuit may, in the public interest, designate and assign temporarily a bankruptcy judge of the circuit to hold a bankruptcy court in any district within the circuit.

"(3) No bankruptcy judge may be designated and assigned for service in a court other than a bankruptcy court.".

(b) The heading of section 293 of title 28, United States Code, is amended to read "Judges of other courts".

(c) The item relating to section 293 in the table of sections of chapter 13 of title 28, United States Code, is amended to read:

"293. Judges of other courts.".

SEC. 7. Section 294(d) of title 28, United States Code, is amended by adding at the end thereof the following: "A retired bankruptcy judge may be designated and assigned only to a bankruptcy court.".

SEC. 8. Section 295 of title 28, United States Code, is amended by striking out "or district" and inserting in lieu thereof ", district, or bankruptcy".

SEC. 9. Section 331 of title 28, United States Code, is amended--

(1) in the first paragraph by striking out "and a district judge from each judicial circuit" and inserting in lieu thereof ", and a district judge and a bankruptcy judge from each judicial circuit,",

(2) in the second paragraph--

(A) by striking out ", except that" and all that follows through "three years", and

(B) by inserting at the end thereof the following: "The bankruptcy judge to be summoned from each judicial circuit shall be chosen by the circuit and bankruptcy judges of the circuit at the annual judicial conference of the circuit held pursuant to section 333 of this title and shall serve as a member of the conference for three successive years, except that in the year following the effective date of this sentence the circuit and bankruptcy judges in the first, fourth, seventh, and tenth circuits shall choose a bankruptcy judge to serve for one year, the circuit and bankruptcy judges in the second, fifth, eighth, and eleventh circuits shall choose a bankruptcy judge to serve for two years and the circuit and bankruptcy judges in the third, sixth, ninth, and District of Columbia circuits shall choose a bankruptcy judge to serve for three years.", and

(3) in the third paragraph--

(A) by striking out "or the district judge" and inserting in lieu thereof "or the district or bankruptcy judge", and

(B) by striking out "or district" and inserting in lieu thereof ", district, or bankruptcy".

SEC. 10. Section 332(a) of title 28, United States Code, is amended--

(1) in paragraph (1)(C)--

(A) by inserting "and bankruptcy judges of the circuit" after "district judges of the circuit", and

(B) in clause (i) and clause (ii) by striking out "the number of district judges" each place it appears and inserting in lieu thereof "the aggregate number of district and bankruptcy judges",

(2) in paragraph (3) by striking out "circuit and district" and inserting "circuit, district, and bankruptcy" in lieu thereof,

(3) in paragraph (4) by striking out "circuit and district" and inserting in lieu thereof "circuit, district, and bankruptcy", and

(4) in paragraph (5) by adding at the end thereof the following: "No more than one bankruptcy judge from any one district shall serve simultaneously on the council, unless

at least one bankruptcy judge from each district within the circuit is already serving as a member of the council.".

SEC. 11. (a) The fourth paragraph of section 372(a) of title 28, United States Code, is amended by striking out "or district" and inserting in lieu thereof ", district, or bankruptcy".

(b) Section 372(b) of title 28, United States Code, is amended by striking out "or district" and inserting in lieu thereof ", district, or bankruptcy".

(c) Section 372(c)(6)(B)(vii) of title 28, United States Code, is amended by striking out "and any removal of a bankruptcy judge shall be in accordance with section 153 of this title".

SEC. 12. The table of sections of chapter 17 of title 28, United States Code, is amended by striking out the item relating to section 375.

SEC. 13. (a) Section 373 of title 28, United States Code, is amended to read as follows:

"§373. Retirement of fixed term judicial officers

"(a) A fixed term judicial officer who retires after serving as least fourteen years, whether continuously or otherwise, as a fixed term judicial officer shall be entitled to receive, during the remainder of his lifetime, an annuity equal to the salary being received at the time of retirement.

"(b) A fixed term judicial officer who retires after serving at least eight years as a fixed term judicial officer shall be entitled to receive, during the remainder of his lifetime, an annuity equal to that proportion of the salary being received at the time of retirement which the aggregate number of years of service bears to fourteen.

"(c) A fixed term judicial officer who has served for at least five years as a fixed term judicial officer, whether continuously or otherwise, and who retires or is removed upon the sole ground of mental or physical disability shall be entitled to receive, during the remainder of his lifetime, an annuity equal to the lesser of the salary being received at the time of retirement or removal or an amount equal to that proportion of the salary being received at the time of retirement or removal which the aggregate number of years of service bears to fourteen.

"(d) An annuity under subsection (a) or (b) of this section shall not become payable until after such fixed term judicial officer has attained the age of sixty-five years.

"(e) A fixed term judicial officer who is entitled to an annuity under this section is also entitled to a cost-of-living adjustment in such annuity, in accordance with the provisions of section 8340(b) of title 5, United States Code, except that no such annuity, as increased under this subsection, shall exceed eighty-five per centum of the salary of a United States district judge in regular active service.

"(f) A fixed term judicial officer who elects to receive an annuity under this section shall not be entitled to receive any annuity to which such fixed term judicial officer would otherwise have been entitled under subchapter III of chapter 83 of title 5, United States Code.

"(g) For purposes of calculating an annuity under this section--

"(1) service as a full-time fixed term judicial officer may be credited; and

"(2) each month of service shall be credited as one-twelfth of a year.".

(b) The item relating to section 373 in the sectional analysis of chapter 17 of title 28, United States Code, is amended to read as follows:

"373. Retirement of fixed term judicial officer.".

(c) The provisions of this Act shall not affect the amount payable to a judge who retired in accordance with the provisions of section 373 of title 28, United States Code, as it existed immediately prior to its amendment by this Act. A judge in active service on the date of enactment of this Act, to whom such prior provisions of section 373 applied, may elect to retire under such prior provisions.

(d)(1) The provisions of section 373 of title 28, United States Code, as amended by this Act, shall apply to a United States bankruptcy judge in active service on the date of enactment of this Act who is not appointed under section 152 of title 28, United States Code, to the bankruptcy court after the date of enactment of this Act.

(2) For purposes of calculating an annuity for a United States bankruptcy judge to whom section 373 of title 28, United States Code, as amended by this Act, applies, service as a United States bankruptcy judge may be credited from October 1, 1979.

(3) In lieu of the annuity otherwise provided under section 373 of title 28, United States Code, as amended by this Act, and notwithstanding the provisions of subsection (d) of such section, a United States bankruptcy judge to whom such section applies shall be entitled, after attaining the age of sixty years, to an annuity computed as provided under subchapter III of chapter 83 of title 5, United States Code, for years of creditable service prior to October 1, 1979, and an annuity calculated, without regard to the number of years of service of such judge, under subsection (b) of section 373 of title 28, United States Code, as amended by this Act, except that the aggregate amount of the annuities payable under this subsection shall not exceed the salary being received at the time of retirement.

SEC. 14. Section 376 of title 28, United States Code, is amended--

(1) by amending subparagraph (a)(1)(B) to read as follows: "(B) a fixed term judicial officer;";

(2) by inserting, at the end of paragraph (a)(1), the following: "or, in the case of a fixed term judicial officer, who so notifies the director on or before the date of an election to retire under section 373 of this title.";

(3) by amending subparagraph (a)(2)(B) to read as follows: "(B) in case of a fixed term judicial officer, an annuity paid under section 373 of this title;"; and

(4) by inserting immediately after the sentence immediately following paragraph (d)(2) thereof the following new sentence: "In the case of a fixed term judicial officer, such deposit shall be made initially from the full amount

which such officer has deposited into the Civil Service Retirement Fund and the balance shall be deposited by such officer."

SEC. 15. Section 451 of title 28, United States Code, is amended--

(1) by striking out "including" and inserting in lieu thereof ", bankruptcy courts," in the paragraph beginning with "The term 'court of the United States' ", and

(2) by inserting "bankruptcy courts," after "district courts," in the paragraph beginning with "The term 'judge of the United States' ".

(3) by designating the existing text thereof as subsection (a);

(4) by designating the existing paragraphs thereof, following the word "title:", as paragraphs (1) through (7), respectively; and

(5) by adding at the end thereof the following: "(8) The term "fixed term judicial officer" means a judge of a territorial court.

SEC. 16. (a) Section 456(b) of title 28, United States Code, is amended--

(1) by striking out "and" the last place it appears, and

(2) by inserting ", and the United States Bankruptcy Court for the District of Columbia" after "United States District Court for the District of Columbia".

(b) Section 456(d) of title 28, United States Code, is amended--

(1) by inserting "and each bankruptcy judge" after "each district judge", and

(2) by inserting "or bankruptcy court, as the case may be," after "a district court".

(c) Section 456(g) of title 28, United States Code, is amended by striking out "or district" and inserting in lieu thereof ", district, or bankruptcy".

SEC. 17. Section 457 of title 28, United States Code, is amended by striking out "of district courts" and inserting in lieu thereof "of bankruptcy courts, of district courts,".

SEC. 18. Section 569(a) of title 28, United States Code, is amended by striking out "of the district court" and inserting in lieu thereof "of the bankruptcy court, of the district court,".

SEC. 19. Section 571(b) of title 28, United States Code, is amended by striking out "and district" and inserting in lieu thereof ", district, and bankruptcy".

SEC. 20. (a) Section 602(b) of title 28, United States Code, is amended by striking out "section 604(a)(15)(B)" and inserting in lieu thereof "section 604(a)(16)(B)".

(b) Section 604(a) of title 28, United States Code, is amended--

(1) by redesignating paragraph (17) as paragraph (18).

(2) in paragraph (10) by striking out "paragraph (17)" each place it appears and inserting in lieu thereof "paragraph (18)",

(3) by redesignating paragraphs (15) and (16) as paragraphs (16) and (17), respectively, and

(4) by redesignating paragraph (14), as added by section 3(c) of the Court Interpreters Act (Public Law 95-539; 92 Stat. 2043), as paragraph (15).

(c) Subsection (f) of section 604 of title 28, United States Code, as added by section 225(b) of the Act of November 6, 1978 (Public Law 95-598; 92 Stat. 2665) is redesignated as subsection (i).

SEC. 21. Section 610 of title 28, United States Code, is amended by striking out "and district courts" and inserting in lieu thereof ", district courts, and bankruptcy courts".

SEC. 22. Section 620(b)(3) of title 28, United States Code, is amended--

(1) by striking out "referees,", and

(2) by striking out "commissioners" and inserting in lieu thereof "magistrates".

SEC. 23. Section 621(a)(2) of title 28, United States Code, is amended by striking out "one" and inserting in lieu thereof "two".

SEC. 24. Section 631(c) of title 28, United States Code, is amended--

(1) by striking out "of the conference, a part-time referee in bankruptcy or" and inserting in lieu thereof "of the conference,", and

(2) by striking out "magistrate and part-time referee in bankruptcy," and inserting in lieu thereof "magistrate and".

SEC. 25. Section 232 of the Act of November 6, 1978 (Public Law 95-598; 92 Stat. 2665) shall take effect on the date of the enactment of this Act.

SEC. 26. (a) Title 28, United States Code, is amended by inserting after chapter 49 the following new chapter:

CHAPTER 50--BANKRUPTCY COURTS

"Sec.

"771. Clerks.
"772. Other employees.
"773. Reporters.
"774. Power to appoint.
"775. Salaries.

"§771. Clerks

"(a) Each bankruptcy court may appoint a clerk who shall be subject to removal by the court.

"(b) The clerk may appoint, with the approval of the court, necessary deputies, clerical assistants, and employees in such number as may be approved by the Director of the Administrative Office of the United States Courts. Such deputies, clerical assistants, and employees shall be subject to removal by the clerk with the approval of the court.

"(c) The clerk of each bankruptcy court shall reside in the district for which he is appointed. The bankruptcy court may designate places within the district for the offices of the clerk and his deputies, and their official stations.

"(d) A clerk of a bankruptcy court or his deputy or assistant shall not receive any compensation or emoluments through any office or position to which he is appointed by the court, other than that received as such clerk, deputy or assistant, whether from the United States or from private litigants.

"(e)(1) The clerk of each bankruptcy court shall pay into the Treasury all fees, costs, and other moneys collected by him, except uncollected fees not rquired by Act of Congress to be prepaid.

"(2) He shall make returns thereof to the Director of the Administrative Office of the United States Courts under regulations prescribed by the Director.

"§772. Other employees

"Bankruptcy judges may appoint necessary other employees, including law clerks and secretaries, subject to any limitation on the aggregate salaries of such employees which may be imposed by law.

"§773. Reporters

"(a)(1) Each bankruptcy court of the United States shall appoint one or more court reporters.

"(2) The number of reporters shall be determined by the Judicial Conference of the United States.

"(3) The qualifications of such reporters shall be determined by standards formulated by the Judicial Conference. Each reporter shall take an oath faithfully to perform the duties of his office.

"(4) Each such court, with the approval of the Director of the Administrative Office of the United States Courts, may appoint additional reporters for temporary service not exceeding three months, when there is more reporting work in the district than can be performed promptly by the authorized number of reporters and the urgency is so great as to render it impracticable to obtain the approval of the Judicial Conference.

"(5) If any such court and the Judicial Conference are of the opinion that it is in the public interest that the duties of reporter should be combined with those of any other employee of the court, the Judicial Conference may authorize such a combination and fix the salary for the performance of the duties combined.

"(b)(1) Each session of the court and every other proceeding designated by rule or order of the court or by one of the judges shall be recorded verbatim by shorthand, mechanical means, electronic sound recording, or any other method, subject to regulations promulgated by the Judicial Conference and subject to the discretion and approval of the judge. The regulations promulgated pursuant to the preceding sentence shall prescribe the types of electronic sound recording or other means which may be used and shall be the same as the regulations promulgated under section 753(b) of this title. Proceedings to be recorded under this section include (A) all proceedings in cases had in open court unless the parties with the approval of the judge shall agree specifically to the contrary and (B) such other proceedings as a judge of the court may direct or as may be required by rule or order of court as may be requested by any party to the proceeding.

"(2) The reporter or other individual designated to produce the record shall attach his official certificate to the original shorthand notes or other original records so taken and promptly file them with the clerk who shall preserve them in the public records of the court for not less than ten years.

"(3) The reporter or other individual designated to produce the record shall transcribe and certify such parts of the record of proceedings as may be required by any rule or order of court unless they have been recorded by electronic sound recording as provided in this subsection and the original records so taken have been certified by him and filed with the clerk as provided in this subsection. He shall also transcribe and certify such other parts of the record of proceedings as may be required by rule or order of court. Upon the request of any party to any proceeding which has been so recorded who has agreed to pay the fee therefor, or of a judge of the court, the reporter or other individual designated to produce the record shall promptly transcribe the original records of the requested parts of the proceedings, attach to the transcript his official certificate, and deliver such transcript to the party or judge making the request.

"(4) The reporter or other designated individual shall promptly deliver to the clerk for the records of the court a certified copy of any transcript so made.

"(5) The transcript in any case certified by the reporter or other individual designated to produce the record shall be deemed prima facie a correct statement of the testimony taken and proceedings had. No transcripts of the proceedings of the court shall be considered as official except those made from the records certified by the reporter or other individual designated to produce the record.

"(6) The original notes or other original records and the copy of the transcript in the office of the clerk shall be open during office hours to inspection by any person without charge.

"(c) The reporters shall be subject to the supervision of the appointing court and the Judicial Conference in the performance of their duties, including dealings with parties requesting transcripts.

"(d) The Judicial Conference shall prescribe records which shall be maintained and reports which shall be filed by the reporters. Such records shall be inspected and audited in the same manner as the records and accounts of clerks of the district courts, and may include records showing--

"(1) the quantity of transcripts prepared;

"(2) the fees charged and the fees collected for transcripts;

"(3) any expenses incurred by the reporters in connection with transcripts;

"(4) the amount of time the reporters are in attendance upon the courts for the purpose of recording proceedings; and

"(5) such other information as the Judicial Conference may require.

"(e) Each reporter shall receive an annual salary to be fixed from time to time by the Judicial Conference of the United

States. All supplies shall be furnished by the reporter at his own expense.

"(f) Each reporter may charge and collect fees for transcripts requested by the parties, including the United States, at rates prescribed by the court subject to the approval of the Judicial Conference. The reporter shall not charge a fee for any copy of a transcript delivered to the clerk for the records of court. Fees for transcripts to persons permitted to appeal in forma pauperis shall also be paid by the United States if the trial judge or an appellate judge certifies that the appeal is not frivolous (but presents a substantial question). The reporter may require any party requesting a transcript to pay the estimated fee in advance except as to transcripts that are to be paid for by the United States.

"(g) If, upon the advice of the chief judge of any bankruptcy court within the circuit, the judicial council of any circuit determines that the number of court reporters provided such bankruptcy court pursuant to subsection (a) of this section is insufficient to meet temporary demands and needs and that the services of additional court reporters for such bankruptcy court should be provided the judges of such bankruptcy court (including the senior judges thereof when such senior judges are performing substantial judicial services for such court) on a contract basis, rather than by appointment of court reporters as otherwise provided in this section, and such judicial council notifies the Director of the Administrative Office, in writing, of such determination, then the Director of the Administrative Office is authorized to and shall contract, without regard to section 3709 of the Revised Statutes of the United States, as amended (41 U.S.C. 5), with any suitable person, firm, association, or corporation for the providing of court reporters to serve such bankruptcy court under such terms and conditions as the Director of the Administrative Office finds, after consultation with the chief judge of the bankruptcy court, will best serve the needs of such bankruptcy court.

"§774. Power to appoint

"Whenever a majority of the bankruptcy judges of any bankruptcy court cannot agree upon the appointment of any officer of such court, the chief judge shall make such appointment.

"§775. Salaries

"The salary of an individual appointed or employed under section 771(a) or 773(a) of this title shall be the same as the salary of an individual appointed or employed under section 751(a) or 753(a) of this title, respectively. The salaries of individuals appointed under section 771(b) of this title shall be comparable to the salaries of individuals appointed under section 751(b) of this title.".

(b) The table of chapters of part III of title 28, United States Code, is amended by inserting after the item relating to chapter 49 the following new item:

"50. Bankruptcy Courts.................................. 771"

SEC. 27. Section 957 of title 28, United States Code, is amended by inserting "or bankruptcy court" after "district court".

SEC. 28. (a) Chapter 83 of title 28, United States Code, is amended by inserting after section 1292 the following new section:

"§1293. Bankruptcy appeals

"(a) The courts of appeals shall have jurisdiction of appeals from all final decisions of bankruptcy appellate panels established in section 159 of this title and from all final decisions of bankruptcy courts for districts to which the application of section 159 of this title is not ordered.

"(b) A court of appeals shall have jurisdiction of an appeal from a final judgment, order, or decree of a bankruptcy appellate panel or, notwithstanding section 1482 of this title, from a final judgment, order, or decree of a bankruptcy court of the United States if the parties to such appeal agree to a direct appeal to the court of appeals.".

(b) The table of sections of chapter 83 of title 28, United States Code, is amended by inserting after the item relating to section 1292 the following new item:

"1293. Bankruptcy appeals.".

SEC. 29. Section 1294 of title 28, United States Code, is amended--

(1) by striking out "district and territorial" and inserting in lieu thereof "district, bankruptcy, and territorial",

(2) by striking out the period at the end thereof and inserting a semicolon, and

(3) by adding at the end thereof the following new paragraphs:

"(5) From a panel of a bankruptcy appellate panel to the court of appeals for the circuit in which the appellate panel is so established.

"(6) From a bankruptcy court of the United States to the court of appeals for the circuit embracing the district in which the bankruptcy court is located.".

SEC. 30. (a)(1) Section 1364 of title 28, United States Code, as added by section 705(f)(1) of the Ethics in Government Act of 1978, is redesignated as section 1365.

(2) Section 705(a) of the Ethics in Government Act of 1978 (2 U.S.C. 288d(a)) is amended by striking out "section 1364" and inserting in lieu thereof "section 1365".

(b) Section 1364 of title 28, United States Code, as added by section 172(c)(1) of the District of Columbia Court Reform and Criminal Procedure Act of 1970 and redesignated as section 1364 by section 6(b)(1) of the Jury System Improvement Act of 1978, is redesignated as section 1366.

(c) The table of sections of chapter 85 of title 28, United States Code, is amended--

(1) in the item relating to section 1330 by striking out "Action" and inserting in lieu thereof "Actions", and

(2) by striking out the three items relating to section 1364 and inserting in lieu thereof the following new items:

"1364. Direct actions against insurers of members of diplomatic missions and their families.
"1365. Senate actions.
"1366. Construction of references to laws of the United States or Acts of Congress.".

SEC. 31. Chapter 85 of title 28, United States Code, is amended--

(1) by striking out section 1334, and

(2) in the table of sections relating to such chapter by striking out the item relating to section 1334.

SEC. 32. Section 1360(a) of title 28, United States Code, is amended by striking out "within the Territory" and inserting in lieu thereof "within the State".

SEC. 33. (a) Title 28 of the United States Code is amended by inserting after chapter 89 the following new chapter:

"CHAPTER 90--BANKRUPTCY COURTS

"Sec.
"1471. Jurisdiction
"1472. Venue of cases under title 11.
"1473. Venue of proceedings arising under or related to cases under title 11.
"1474. Venue of cases ancillary to foreign proceedings.
"1475. Change of venue.
"1476. Creation or alteration of district or division.
"1477. Cure or waiver of defects.
"1478. Removal to the bankruptcy courts.
"1479. Provisonal remedies; security.
"1480. Jury trials.
"1481. Powers of bankruptcy court.
"1482. Appeals.

"§1471. Jurisdiction

"(a) Except as provided in subsection (b) of this section, the bankruptcy courts shall have original and exclusive jurisdiction of all cases under title 11.

"(b) Notwithstanding any Act of Congress that confers exclusive jurisdiction on a court or courts other than the bankruptcy courts, the bankruptcy courts shall have original but not exclusive jurisdiction of all civil proceedings arising under title 11 or arising in or related to cases under title 11.

"(c) Subsection (b) of this section does not prevent a bankruptcy court, in the interest of justice, from abstaining from hearing a particular proceeding arising under title 11 or arising in or related to a case under title 11. Such abstention, or a decision not to abstain, is not reviewable by appeal or otherwise.

"(d) The bankruptcy court in which a case under title 11 is pending shall have exclusive jurisdiction of all of the property, wherever located, of the debtor, as of the commencement of the case.

"§1472. Venue of cases under title 11

"Except as provided in section 1474 of this title, a case under title 11 may be commenced in the bankruptcy court for a district--

"(1) in which the domicile, residence, principal place of business, in the United States, or principal assets, in the United States, of the person or entity that is the subject of such case have been located for the one hundred and eighty days immediately preceding such commencement, or for a longer portion of such one hundred and eighty-day period than such domicile, residence, principal place of business, in the United States, or principal assets, in the United States, were located in any other district; or

"(2) in which there is pending a case under title 11 concerning such person's affiliate, general partner, or partnership.

"§1473. Venue of proceedings arising under or related to cases under title 11

"(a) Except as provided in subsections (b) and (d) of this section, a proceeding arising under title 11 or arising in or related to a case under title 11 may be commenced in the bankruptcy court in which such case is pending.

"(b) Except as provided in subsection (d) of this section, a trustee in a case under title 11 may commence a proceeding arising in or related to such case to recover a money judgment of or property worth less than $1,000 or a consumer debt of less than $5,000 only in the bankruptcy court for the district in which a defendant resides.

"(c) Except as provided in subsection (b) of this section, a trustee in a case under title 11 may commence a proceeding arising in or related to such case as statutory successor to the debtor or creditors under section 541 or 544(b) of title 11 in the bankruptcy court for the district where the State or Federal court sits in which, under applicable nonbankruptcy venue provisions, the debtor or creditors, as the case may be, may have commenced an action on which such proceeding is based if the case under title 11 had not been commenced.

"(d) A trustee may commence a proceeding arising under title 11 or arising in or related to a case under title 11 based on a claim arising after the commencement of such case from the operation of the business of the debtor only in the bankruptcy court for the district where a State or Federal court sits in which, under applicable nonbankruptcy venue provisions, an action on such claim may have been brought.

"(e) A proceeding arising under title 11 or arising in or related to a case under title 11, based on a claim arising after the commencement of such case from the operation of the business of the debtor, may be commenced against the representative of the estate in such case in the bankruptcy court for the district where the State or Federal court sits in which the party commencing such proceeding may, under applicable nonbankruptcy venue provisions, have brought an action on such claim, or in the bankruptcy court in which such case is pending.

"§1474. Venue of cases ancillary to foreign proceedings

"(a) A case under section 304 of title 11 to enjoin the commencement or continuation of an action or proceeding in a State or Federal court, or the enforcement of a judgment, may be commenced only in the bankruptcy court for the district where the State or Federal court sits in which is pending the action or proceeding against which the injunction is sought.

"(b) A case under section 304 of title 11 to enjoin the enforcement of a lien against property, or to require turnover of property of an estate, may be commenced only in the bankruptcy court for the district in which such property is found.

"(c) A case under section 304 of title 11, other than a case specified in subsection (a) or (b) of this section, may be commenced only in the bankruptcy court for the district in which is located the principal place of business in the United States, or the principal assets in the United States, of the estate that is the subject of such case.

"§1475. Change of venue

"A bankruptcy court may transfer a case under title 11 or a proceeding arising in or related to such case to a bankruptcy court for another district, in the interest of justice and for the convenience of the parties.

"§1476. Creation or alteration of district or division

"Cases or proceedings pending at the time of the creation of a new district or division or transfer of a county or territory from one division or district to another may be tried in the district or division as it existed at the institution of the case or proceeding, or in the district or division so created or to which the county or territory is so transferred as the parties shall agree or the court direct.

"§1477. Cure or waiver of defects

"(a) The bankruptcy court of a district in which is filed a case or proceeding laying venue in the wrong division or district may, in the interest of justice and for the convenience of the parties, retain such case or proceeding, or may transfer, under section 1475 of this title, such case or proceeding to any other district or division.

"(b) Nothing in this chapter shall impair the jurisdiction of a bankruptcy court of any matter involving a party who does not interpose timely and sufficient objection to the venue.

"§1478. Removal to the bankruptcy courts

"(a) A party may remove any claim or cause of action in a civil action, other than a proceeding before the United States Tax Court or civil action by a governmental unit to enforce such governmental unit's police or regulatory power, to the bankruptcy court for the district where such civil action is pending, if the bankruptcy courts have jurisdiction over such claim or cause of action.

"(b) The court to which such claim or cause of action is removed may remand such claim or cause of action on any equitable ground. An order under this subsection remanding a claim or cause of action is not reviewable by appeal or otherwise.

"§1479. Provisional remedies; security

"(a) Whenever any action is removed to a bankruptcy court under section 1478 of this title, any attachment or sequestration of the goods or estate of the defendant in such action shall hold the goods or estate to answer the final judgment or decree in the same manner as they would have been held to answer final judgment or decree had it been rendered by the court from which the action was removed, unless the attachment or sequestration is invalidated under applicable law.

"(b) Any bond, undertaking, or security given by any party in an action prior to removal under section 1478 of this title shall remain valid and effectual notwithstanding such removal, unless such bond, undertaking, or other security is invalidated under applicable law.

"(c) All injunctions, orders, and other proceedings in an action prior to removal of such action under section 1478 of this title shall remain in full force and effect until dissolved or modified by the bankruptcy court.

"§1480. Jury trials

"(a) Except as provided in subsection (b) of this section, this chapter and title 11 do not affect any right to trial by jury, in a case under title 11 or in a proceeding arising under title 11 or arising in or related to a case under title 11, that is provided by any statute in effect on September 30, 1979.

"(b) The bankruptcy court may order the issues arising under section 303 of title 11 to be tried without a jury.

"§1481. Powers of bankruptcy court

"A bankruptcy court shall have the powers of a court of equity, law, and admiralty.

"§1482. Appeals

"(a) Bankruptcy appellate panels established in section 159(a) of this title shall have jurisdiction of appeals from all final judgments, orders, and decrees of bankruptcy courts.

"(b) Bankruptcy appellate panels shall have jurisdiction of appeals from interlocutory judgments, orders, and decrees of bankruptcy courts, but only by leave of the panel to which the appeal is taken.".

(b) The table of chapters of part IV of title 28 of the United States Code is amended by inserting after the item relating to chapter 89 the following new item:

"90. Bankruptcy Courts.................................. 1471.".

SEC. 34. Section 1656 of title 28, United States Code, is amended by inserting "or in a bankruptcy court" after "a district court".

SEC. 35. Section 1827(i) of title 28, United States Code, is amended by striking out "referee in bankruptcy" and inserting in lieu thereof "bankruptcy judge".

SEC. 36. Section 1869(f) of title 28, United States Code, is amended by inserting "chapter 6 of title 28, United States Code," after "chapter 5 of title 28, United States Code,".

SEC. 37. Section 1962 of title 28, United States Code, is amended by inserting "or bankruptcy court" after "district court".

SEC. 38. Section 1963 of title 28, United States Code, is amended--

(1) in the first paragraph by inserting "or bankruptcy court" after "district court" the first place it appears,

(2) in the first sentence of the first paragraph by inserting "with the clerk of the district court or the bankruptcy court, whichever is appropriate" before the period at the end thereof, and

(3) by adding at the end thereof the following new undesignated paragraph:

"An order of discharge or an order of confirmation in a case under title 11 which has become final may be registered in any other district by filing in the office of the clerk of the bankruptcy court of that other district a certified copy of the order and when so registered shall have the same effect as an order of the bankruptcy court of the district where so registered and may be enforced in like manner.".

SEC. 39. Section 2107 of title 28, United States Code, is amended--

(1) by inserting "or the bankruptcy court" after "district court", and

(2) by striking out the last paragraph.

SEC. 40. Section 2109 of title 28, United States Code, is amended by inserting "or from a bankruptcy court" after "from a district court".

SEC. 41. (a) Chapter 153 of title 28, United States Code, is amended by adding at the end thereof the following new section:

"§2256. Habeas corpus from bankruptcy courts

"A bankruptcy court may issue a writ of habeas corpus--

"(1) when appropriate to bring a person before the court--

"(A) for examination;

"(B) to testify; or

"(C) to perform a duty imposed on such person under this title or title 11; or

"(2) ordering the release of a debtor in a case under title 11 in custody under the judgment of a Federal or State court if--

"(A) such debtor was arrested or imprisoned on process in any civil action;

"(B) such process was issued for the collection of a debt--

"(i) that is dischargeable under title 11; or

"(ii) that is or will be provided for in a plan under chapter 11 or 13 of title 11; and

"(C) before the issuance of such writ, notice and a hearing have been afforded the adverse party of such debtor in custody to contest the issuance of such writ.".

(b) The table of sections for chapter 153 of title 28, United States Code, is amended by adding at the end thereof the following new item:

"2256. Habeas corpus from bankruptcy courts.".

SEC. 42. Rule 1101(a) of the Federal Rules of Evidence is amended by inserting "the United States bankruptcy courts," after "the United States district courts,".

SEC. 43. (a) Section 8331(22) of title 5, United States Code, is amended--

(1) in subparagraph (A)--

(A) by striking out "March 31, 1984" and inserting in lieu thereof "on September 30, 1985, or until such judge's successor is appointed", and

(B) by striking out "under section 201 of this Act" and inserting in lieu thereof "under section 151 of title 28, United States Code,", and

(2) in subparagraph (B) by striking out "during the transition period" and inserting in lieu thereof "between October 1, 1979, and September 30, 1985, inclusive,".

(b) Subsections (f), (i), (j), (k), (l), and (m) of section 8339, subsections (b)(1) and (d) of section 8341, and section 8344(a)(4)(A) of title 5, United States Code, are each amended by striking out "and (o)" and inserting in lieu thereof "and (n)".

SEC. 44. Section 2(a) of the Act of November 8, 1977 (Public Law 95-157; 91 Stat. 1266) is amended by inserting "and a bankruptcy court" after "district court".

SEC. 45. (a) Section 402(b) of the Act of November 6, 1978 (Public Law 95-598; 92 Stat. 4682) is amended by striking out "shall take effect on April 1, 1984" and inserting in lieu thereof "shall not take effect".

(b) Section 402(e) of the Act of November 6, 1978 (Public Law 95-598; 92 Stat. 2682) is amended by striking out "April 1, 1984" and inserting in lieu thereof "the date of enactment of the Bankruptcy Court Act of 1983".

SEC. 46. (a) Section 406(a) of the Act of November 6, 1978 (Public Law 95-598; 92 Stat. 2686) is amended--

(1) by striking out paragraph (2), and

(2) in paragraph (1)--

(A) by striking out "(1)",

(B) by striking out "During the transition period, the" and inserting in lieu thereof "The"..

(C) in subparagraph (A)--

(i) by striking out "(A)" and inserting in lieu thereof "(1)", and

(ii) by striking out "section 201 of this Act" and inserting in lieu thereof "section 151 of title 28, United States Code,", and

(b) in subparagraph (B) by striking out "(B)" and inserting in lieu thereof "(2)".

(b) Section 406(b) of the Act of November 6, 1978 (Public Law 95-598; 92 Stat. 2686) is amended by striking out "section 201 of this Act" and inserting in lieu thereof "section 151 of title 28, United States Code,".

SEC. 47. Sections 404, 405(a), 405(b), 405(c), 407(c), 409, and 410 of the Act of November 6, 1978 (Public Law 95-598; 92 Stat. 2683) are repealed.

SEC. 48. (a) The offices of bankruptcy judges for which appointments are authorized, by laws in effect immediately preceding the date of enactment of this Act, to be made in a judicial district shall constitute the bankruptcy court of such judicial district during the period beginning on the date of enactment of this Act and ending on September 30, 1985 (hereinafter in this Act referred to as the "transition period").

(b) The bankruptcy courts established in subsection (a) shall be deemed to be the bankruptcy courts for purposes of--

(1) this Act,

(2) the Acts amended by this Act,

(3) title 28 of the United States Code, as amended by this Act, other than sections 152, 293(b), 294, 295, 331, 372, and 451 of such title,

(4) title 11 of the United States Code, and

(5) the Acts amended by the Act of November 6, 1978 (Public Law 95-598; 92 Stat. 2549).

(c) During the transition period and in addition to cases and proceedings commenced during such period, all cases under title 11 of the United States Code and all proceedings arising under title 11 of the United States Code or arising in or related to a case under title 11 of the United States Code pending on the date of enactment of this Act shall be heard by the bankruptcy courts specified in subsection (a) as though such cases and proceedings had been commenced in such courts.

SEC. 49. (a) Judges of the bankruptcy courts established in section 48(a) of this Act shall have the title United States bankruptcy judges.

(b) During the transition period United States bankruptcy judges may exercise the jurisdiction and powers conferred by title 28 and title 11 of the United States Code on bankruptcy courts.

(c) Notwithstanding section 34a of the Bankruptcy Act in effect on September 30, 1979, and section 404(b) of the Act of November 6, 1978, as in effect before the date of enactment of this Act, the term of office of a United States bankruptcy judge who is serving on the date of enactment of this Act in a bankruptcy court established in section 48(a) expires on the date such judge's successor is appointed or on September 30, 1985, whichever occurs first.

(d) During the transition period the levels of salaries of United States bankruptcy judges who are serving on the date of enactment of this Act in the bankruptcy courts established in section 48(a) are continued at the levels in effect on the date of the enactment of this Act, subject to adjustment under section 225 of the Federal Salary Act of 1967 (2 U.S.C. 351-361) and section 461 of title 28, United States Code.

(e)(1) During the transition period an appeal from a judgment, order, or decree of a United States bankruptcy judge shall be--

(A) if the judicial council of the circuit in which the bankruptcy judge sits so orders for the district in which the bankruptcy judge sits, to a panel of three bankruptcy judges appointed in the manner described in section 159 of title 28, United States Code, as added by section 2 of this Act,

(B) if no panel is appointed under subparagraph (A) for the district in which such bankruptcy judge sits, to the district court for such district.

(C) if the parties to the appeal agree to a direct appeal to the court of appeals for such circuit, to such court of appeals, or

(2) During the transition period the district courts of the United States shall have jurisdiction to hear appeals from the judgments, orders, and decrees of bankruptcy courts.

(3) During the transition period a panel referred to in paragraph (1)(A) shall be deemed to be a bankruptcy appellate panel referred to in section 1293 of title 28, United States Code.

SEC. 50. (a) On October 1, 1985, there shall be transferred to the appropriate United States bankruptcy court established in section 151(a) of title 28, United States Code--

(1) cases, and matters and proceedings in cases, under the Bankruptcy Act that are pending, at the end of September 30, 1985, in the bankruptcy courts established in section 48(a) of this Act, other than cases, and matters and proceedings in cases under--

(A) Section 77 or Chapter IX of the Bankruptcy Act, or

(B) Chapter X of the Bankruptcy Act in which a general reference under section 117 of the Bankruptcy Act is not in effect, and

(2) cases under title 11 of the United States Code, and proceedings arising under title 11 of the United States Code or arising in or related to cases under title 11 of the United States Code, that are pending at the end of September 30, 1985, in the bankruptcy courts established in section 48(a) of this Act.

(b) On October 1, 1985, there shall be transferred to the appropriate bankruptcy appellate panels established in section 159 of title 28, United States Code, appeals from final judgments, orders, and decrees of the bankruptcy courts established in section 48(a) pending at the end of September 30, 1985, in the panels appointed under section 49(e)(1)(A).

SEC. 51. (a) Notwithstanding section 152 of title 28, United States Code, as added by section 2 of this Act--

(1) bankruptcy judges may not be appointed before February 1, 1984 to more than 75% of the offices specified in such section, and

(2) bankruptcy judges may not be appointed before February 1, 1985 to more than 15% of the offices specified in such section.

(3) Paragraphs (1) and (2) shall not apply to the appointment of a bankruptcy judge continued in office under section 49(c) of this Act to succeed himself.

(b)(1) Notwithstanding section 152 of title 28, United Sates Code, as added by section 2 of this Act, and except as provided in paragraph (2) of this subsection, bankruptcy judges who are appointed under such section after the date of the enactment of this Act shall be apointed to succeed bankruptcy judges continued in office under section 49(c) of this Act as follows:

(A) One bankruptcy judge shall be appointed under section 152 of title 28, United States Code, for each judicial district specified in such section.

(B) Only after the bankruptcy judges described in subparagraph (A) have been appointed may other bankruptcy judges be appointed under such section 152.

(C) In a judicial district served by two or more bankruptcy judges continued in office under section 49(c) of this Act, such judges shall be replaced in the order of [first] [last] to enter on duty.

(2) Paragraph (1) shall not apply with respect to the appointment of a bankruptcy judge to fill a vacancy in office created by the death or retirement of a bankruptcy judge.

SEC. 52. For purposes of sections 153, 154, 293(b), 294, 295, 331, 372, and 451 of title 28, United States Code, as added by this Act, bankruptcy judges appointed under section 152 of title 28, United States Code, in the transition period shall be deemed during such period to be appointed to the bankruptcy courts established in section 151(a) of title 28, United States Code, as added by section 2 of this Act, and such sections shall apply to such judges during such period.

SEC. 53. The Supreme Court may issue such additional rules of procedure, consistent with Acts of Congress, as may be necessary for the orderly transfer of functions and records and the orderly transition to the new bankruptcy court system created by this Act.

SEC. 54. (a) Whenever the President is authorized to fill a vacancy that occurs in a bankruptcy court of the United States, the President shall nominate as a bankruptcy judge to fill that vacancy a person whose character, experience, ability, and impartiality qualify such person to serve in the Federal judiciary.

(b) The Attorney General of the United States shall assist the President by evaluating potential nominees and by recommending to the President for consideration for appointment persons who are qualified to be bankruptcy judges.

(c) Before transmitting to the President the names of the persons he deems best qualified to fill any existing vacancy, the Attorney General shall have determined that--

(1) public notice of such vacancy has been given and an affirmative effort has been made, in the case of each such vacancy, to identify qualified candidates, without discrimination as to race, color, sex, religion, or natural origin,

(2) such persons are members in good standing of at least one State bar, or the District of Columbia bar, and members in good standing of every other bar of which they may be members,

(3) such persons possess, and have a reputation for, integrity and good character,

(4) such persons are of sound physical and mental health,

(5) such persons possess and have demonstrated commitment to equal justice under law,

(6) such persons possess and have demonstrated outstanding legal ability and competence, as evidenced by substantial legal experience, ability to deal with complex legal problems, aptitude for legal scholarship and writing, and familiarity with courts and court processes, and

(7) such persons' demeanor, character, and personality indicate that they would exhibit judicial temperament if appointed to the position of United States bankruptcy judge.

SEC. 55. (a) Except as provided in subsection (b), this Act and the amendments made by this Act shall take effect on the date of the enactment of this Act.

(b) Sections 151(a), 153, 154, and 159 of title 28, United States Code, as added by section 2 of this Act, shall take effect on October 1, 1985.

PREPARED STATEMENT OF L. E. CREEL, III

Mr. Chairman, I appreciate the opportunity to testify before the Subcommittee. I am a partner in the law firm of Creel & Atwood of Dallas, Texas, with an extensive practice in commercial and bankruptcy law. I appear today on behalf of the American Bankruptcy Institute, of which I am the President.

The American Bankruptcy Institute is a newly formed non-profit, non-partisan organization whose major purpose is to assist in the education of the bar and other interested persons regarding bankruptcy in the American jurisprudence and economic systems. The Institute also provides input to the Congress for the reform of the bankruptcy laws. The Institute has an open membership. It is open to all individuals--lawyers, bankers, judges, businessmen, legislators, professors--who have an interest in bankruptcy matters. It presently has a Washington office, counsel, an active board of directors and officers, a national newsletter in its first edition, scheduled seminars and other educational activities. It is not a trade association formed to lobby Congress.

On January 7, 1983, members of the American Bankruptcy Institute at the request of Senator DeConcini and former Congressman Caldwell Butler, helped organize a National Conference on the Resolution of the Bankruptcy Crisis here in Washington. More than 100 experts in bankruptcy law and the bankruptcy judicial system gathered to participate in a day long forum which served, I believe, as a means of focusing national attention on the chaotic status of the American bankruptcy courts since the Supreme Court decision in Marathon. The conference was covered gavel-to-gavel by the public service cable network C-SPAN and portions of the conference have been aired nationally several times in recent weeks.

The conference participants were an impressive group including a United States Senator (Senator DeConcini, a member of the Senate Judiciary Committee and previous Chairman of this

Subcommittee), former Congressman Caldwell Butler, a U.S. Circuit judge, a U.S. District judge, a number of bankruptcy judges, representatives from the Administrative Office of the U.S. Courts, the Director of Staff Attorneys of the Ninth Circuit U.S. Court of Appeals, members of the National Bankruptcy Conference, representatives of the Commercial Law League, law professors, practioners, bankers and businessmen from around the country. In short, Mr. Chairman, the credentials of the participants speak for themselves. The record of the conference supports the conclusions I will present today. In that regard, Mr. Chairman, I would ask that the transcript of the January 7, 1983, Conference be made a part of the hearing record.

Mr. Chairman, I am going to keep my presentation brief and address four points which will be supported by way of footnotes quoting participants attending the January 7 conference.

First, there was general agreement that there exists a present crisis in the bankruptcy system caused by the jurisdictional uncertainties introduced by the Marathon decision which was left uncorrected by Congress late last session. I will observe, Mr. Chairman, that the record does show that you and other members of the Senate Judiciary Committee were prepared to move on this matter, but were unable to do so because of the parliamentary situation.

Nonetheless, the crisis is still with us and is recognized to be a major factor in the prospects for an improvement in the economy and employment.[1] The participants did not hesitate to relate examples of how the current crisis in the bankruptcy system adversely affects almost every aspect of our economy,[2] especially the lending community.[3]

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[1] "I have become aware of the genuine fear that exists among the diverse and widespread segment of the Nation that the bankruptcy system is, indeed, on the verge of collapse." (Senator Dennis DeConcini, at p. 3 of transcript of "National Conference on the Resolution of the Bankruptcy Crisis").

Second, it was clear from the conference that the "emergency rule" promulgated by the Judicial Conference of the United States as a response to the Marathon decision is, at best, unclear and temporary.[4] In the opinion of most it was adopted without legal authority, is subject to substantial constitutional question[5] and is, practically speaking, unworkable.[6]

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[2] "As a result, (of Marathon), a cloud hangs over these courts, particularly with regard to farmers, since, in order to put in next year's crops, typically a farmer must ask the Court to rearrange state law rights; for instance, to ask someone who holds the lien on his next year's crop to take a second position in order to encourage a new lender to put up some money so that he can plow and plant." (Ralph Mabey, Bankruptcy Judge, Salt Lake City, Utah; at p. 49).

[3] "I think what bothers me most is the impact on human beings. We are in a recession. One-third of our industry has problems. The employees and the stockholders and the financial institutions in some areas are hanging on by the skin of their teeth. To now create a situation where for six months, or some other period of time, we are going to be in the bifurcated court system, and then even when that is corrected not know whether all the constitutional reservations that have occurred during this period are going to come back to haunt us, I think is going to make a terrible, terrible impact on the country and business." (Mr. Robert Grimmig, Executive Vice President, Chemical Bank of New York, at pp. 45-46).

[4] "Again, I repeat, it is not intended by the Judicial Conference to be a final answer. It is not intended to reflect in any way whatsoever opinions of any members of the Supreme Court of the United States, including the Chief Justice." (William J. Weller, Legislative Affairs Director, Administrative Office of the U.S. Courts, at p. 103) and, "Judge Rubin, I think, has put in perspective and proper focus what the rule is intended to do. Certainly, it is not remedial. It is simply stop-gap and what the Judicial Conference perceived as a measure that it needed to take in order to be able to continue what we had." (Honorable Morey L. Sear, U.S. District Judge, Eastern District of Louisiana, at p. 107).

[5] " . . . I don't think anyone really knows for certain what a majority of the judges in Marathon feel has to be decided by an Article III judge. If there is something that is not picked up by the phrase "related proceedings" that has to be decided by an Article III judge, then it seems to me that we are dealing with a rule that might not be valid." (Professor David Epstein, University of Texas Law School, at p. 123).

In fairness, there was an opinion expressed by a few bankruptcy and Federal judges that the "emergency rule was working".[7]

Third, it was clear from the record that congressional action is necessary to correct the system, notwithstanding the existence of the emergency rule. The jurisdictional issue and the court structure which is required to achieve its resolution demands the full attention of and prompt action by the

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[6] "With this background, I can say today that as a commercial lender, Vernon, I am extremely disturbed and concerned and rather apprehensive about the forthcoming period under the so-called "rule." I am not an attorney but, speaking as a layman in the law and as a professional money lender, as I understand the rule as it is written, it simply does not provide the comfort of finality and conclusiveness that is absolutely essential to a money lender financing a business under the umbrella of bankruptcy." (Mr. Thomas Drennan, President, Wells Fargo Business Credit, Dallas, Texas, at p. 38), and, "The thrust of the matter is that during the last 10 days or so I have discussed the Marathon emergency rule situation with a number of people. Some of these people are dealing with airline credits, some are not . . . The most disturbing part of this is that I can speak with men whom I have known for years whom I regard as able judges or able ex-judges or fine practioners, and we cannot agree on some very fundamental things that we should be able to agree upon." (Mr. Bert Freeman, General Counsel, Bankers Trust, New York, New York, at pp. 27-28).

[7] "I am glad to tell you that the bankruptcy system in Los Angeles is alive and well. Since the new rule, I have had approximately 300 adversaries that have been brought on in the usual course of my calendar. The lawyers have conducted themselves just as they do before the rule, before the 24th of December. They have all been disposed of because we try everything the first time around in my shop. The orders are coming in. We have no difficulty."

"I believe that this rule, if the lawyers and the bankruptcy judges have a District Court which is committed to making the system function until Congress acts, I think this rule can serve the needs of something over 90 percent of the bankruptcy cases that we see." (Honorable Robert Ordin, U.S. Bankruptcy Judge, Los Angeles, Calif., at p. 158). And,

"There is danger on both sides...but I know I feel that I will ride the tide and see if I can make the system work. Whether or not I make the rule work, that is something else. When I am called upon to make a decision, I will make it. I am willing to ride with the tide." (Honorable John Galgay, Bankruptcy Judge, at pp. 163-164).

Congress. To not act promptly, in the view of some, would be tragic.[8]

Finally, I think I can state unequivocally for this record that the consensus of the January 7 conference was that the best and most reasonable solution to the Marathon decision was for bankruptcy cases to be handled by Article III judges. After carefully considering other alternatives and combinations of alternatives, including de novo trials, arbitrary withdrawal of references, attempted division of jurisdiction or function between the bankruptcy courts and other courts, use of bankruptcy judges as referees, use of U.S. district courts as reviewers, there was general agreement that Article III court status for bankruptcy judges was the preferred alternative. Of course, Congress must weigh a number of factors in reaching any conclusion on this issue.

Mr. Chairman, there are fears, and they have been expressed today, that if, for example, 227 sitting bankruptcy judges are given Article III status, what will we do with all of these new life-tenured bankruptcy judges when the current crisis is over? There are two possible answers to that question: (1) Congress appeared to believe that such a number of judges was necessary as it provided for their existence in the transition section of the 1978 Code; and (2) one possible solution is to give them partially or wholly fungible jurisdiction, thus allowing them to handle cases other than those arising out of or related to Chapter 11 of the U.S. Code. Whatever course is taken by the Congress it must be acknowledged that if current economic conditions persist, and our population retains its litigious tendencies, more, not less judges may be needed.

Mr. Chairman, the majority of the participants recognize the need for substantive reforms in the 1978 Bankruptcy Code, but those attending the conference also expressed strongly the view that a resolution of the constitutionality of the bankruptcy courts must be reached immediately. A political consensus needs to be formed on this issue. Each day Congress delays costs money and jobs and can mean human misery for many Americans. In our current economy, as unfortunate as it is, bankruptcy has become an everyday occurrence throughout America. Without a constitutional and effective bankruptcy system those needs cannot be properly met. The American Bankruptcy Institute and its membership urges Congress to act promptly.

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[8] "I am impressed with how complicated the congressional decision is. It is very similar probably to what was faced on December 8, 1941, on whether or not to mobilize . . It is still unbelieveable to me that there was no action by December the 24th. Any congressional action that establishes this Court will be responsible, and every day that it is delayed is immeasurably irresponsible in my judgement." (Mr. David Kline, Kline & Kline, Oklahoma City, Oklahoma, at pp. 86-87).

CONSUMER CREDIT CODE AMENDMENTS

Senator **Dole**. We are now moving into a different area. We have put away the *Northern Pipeline* v. *Marathon Pipeline* decision. I will say the hearing record will be open, because this is highly important, and if there are others who would like to submit statements for the record—who may be in the audience or may not be in the audience—the hearing record will remain open for a period of time.

We now move to the Consumer Credit Code Amendments. It is a matter of particular interest to Senator Metzenbaum, and he has addressed that in his earlier remarks. It is my hope that we can find some way to resolve this.

There are only a couple of issues at stake, and I hope we can focus on those. There are 17 witnesses left and we hope to finish this morning.

The first panel is Robert Evans, executive vice president, National Consumer Finance Association; Bill W. Dixon, testifying on behalf of the American Bankers Association; D. V. Beall, manager, NASA Federal Credit Union, representing Credit Union National Association, Inc.; and Raymond Klein, representing the American Retail Federation.

STATEMENTS OF ROBERT EVANS, EXECUTIVE VICE PRESIDENT, NATIONAL CONSUMER FINANCE ASSOCIATION; BILL W. DIXON, FIRST VICE PRESIDENT, FIRST WISCONSIN MILWAUKEE, REPRESENTING THE AMERICAN BANKERS ASSOCIATION; D. V. BEALL, MANAGER, NASA FEDERAL CREDIT UNION, REPRESENTING CREDIT UNION NATIONAL ASSOCIATION, INC.; AND RAYMOND KLEIN, REPRESENTING THE AMERICAN RETAIL FEDERATION

Senator **Dole**. Mr. Evans, would you start?

Mr. **Evans**. Thank you, Mr. Chairman.

I am here today testifying on behalf of the National Coalition for Bankruptcy Reform. I am not their lobbyist. I am their national coordinator.

Senator **Heflin**. You have a $500 suit on. [Laughter.]

Mr. **Evans**. You cannot get away with a thing.

Mr. Chairman, I would like to have my full statement incorporated into the record.

Senator **Dole**. It will be made part of the record as well as other statements on the panel.

Mr. **Evans**. I have submitted some supplemental exhibits here as follows: a chart of personal bankruptcies, 1969 to 1982; another chart of bankruptcy filings per 1,000 households, relating to consumer installment credit outstanding in 1972 dollars per household; a table comparing chapter 13 filings in the three lowest States with the five highest States; a study recently made by the Purdue University on 5,000 chapter 13 accounts, which I think has a bearing on the other two Purdue studies, which I also submit for the record, volumes 1 and 2, which we introduced in the last Congress and which I would also like to have incorporated in the record.

Senator **Dole**. Right. We will make them by reference a part of the record. We will not reprint each of the studies in the official record because of cost.

Mr. **Evans**. Thank you.

I might point to the chart relating to personal bankruptcies and indicate, as you mentioned earlier, personal bankruptcies for the fiscal year 1982 were almost exactly where they are for the year before, which was almost 450,000. There has not been any decrease. There has been a leveling off, but at an extremely high level.

If you look at exhibit 2, you see that we are now running at an annual rate of about twice what we had in the prior, oh, 20 years, and that this can only be explained, we think, in part, by the code as well as, of course, the recession and inflation and that sort of thing.

But if you will look at the consumer credit outstanding in 1972 dollars, you will see that, contrary to the illusion that has been created here by the actual dollars of consumer credit outstanding, in 1972 dollars per household we only have a little less than $2,000 per household in consumer credit outstanding. That is the lowest it has been since the early 1970's, and in a sense we are really going down in consumer credit outstanding as opposed to having an increase.

Indeed, in 1980 we had about $310 billion outstanding. We now have $335 billion. We have actually—in a period of a 25-percent increase in the CPI—we have actually had a decrease in consumer credit outstanding.

Why is this important to what we are going to talk about? Simply because if we are going to have an economic recovery, consumer credit is always one of the leading ways in which this comes about.

The consumer on the average now is in the best condition he has been since Eisenhower left office. His liquid assets as a percentage of his income, the amount of disposable income which is applied to repayment of debt, is the lowest it has been in 20 years.

So we cannot generalize from these apparent figures that there has been a credit explosion, and the consumer has been caught up in it and is laboring to get out of the tremendous burden. It just is not so.

Chart 3—and this is all new evidence, which is the reason I am putting it on at this time—we have prepared, and this goes to the crux of the problem, the five lowest States in the chapter 13 filings. I think you are aware that there are two types of bankruptcy relief. There is chapter 13, which is the repayment plan, and the other is chapter 7, in which the debts are discharged entirely.

The problem in our view is that not enough consumers are using chapter 13. One out of 14 consumers actually uses chapter 13 in the lowest States. In the highest States, we have 60 percent, 6 out of 10, using chapter 13. This cannot be accounted for by demographic evidence, but simply indicates that the Bankruptcy Act is working in a very piecemeal fashion. That is why we have introduced and put before your committee for consideration the threshold test that we have had considered last time.

Quickly summing up, the threshold test has been subjected to criticism on several counts.

No. 1, there are people out there in bankruptcy in chapter 7 that cannot pay their debts. In other words, everyone who takes bankruptcy needs that fresh start. The Purdue study establishes that that is not the case. About one in four people taking straight bankruptcy today have the capacity to pay their debts.

A judge that you confirmed as district court judge last time testified in 1975 before the House:

> There is a widespread awareness and acceptance of the bankruptcy law that an honest debtor ought not to be required to pay his debts when it would be a real hardship for him to do so, but it is just as widespread an attitude that the shirking of obligations should not be condoned by the law.

He said that the bankruptcy law is a workable standard to determine the right to bankruptcy relief by deserving debtors. That is what we are trying to find here, Mr. Chairman, one that is fair and not susceptible of abuse by other parties and used by those taking chapter 7 who need a fresh start.

Why is there any resistance at all to a standard that has denied discharge to a regularly employed debtor who has the disposable income to pay his debts? It has been urged that some debtors who need a fresh start might be denied it.

We think this concern is unwarranted. It is based on the mistaken notion that the courts cannot fairly distinguish the deserving from the undeserving, those who can pay from those who cannot pay.

This is a function of courts, exercised everyday, and commonsense dictates the courts——

Senator DOLE. I'm sorry to interrupt you, Mr. Evans, but your time has expired and we do need to move on. Perhaps you can conclude your remarks after we have heard from other witnesses.

Particularly since this matter has passed the committee and the subcommittee, I hope we could deal on the future income problem, which is the one in controversy.

Mr. Lowrie.

Mr. DIXON. Mr. Lowrie is not here this morning.

My name is Bill Dixon, first vice president of First Wisconsin Milwaukee, and I am representing the American Bankers Association, and I will try to be very brief.

To get right to the point, the association believes that article III judges are necessary to most effectively deal with bankruptcy matters. Our written statement, which is part of the record, sets forth the reasons why the association believes that article III bankruptcy judges specializing in bankruptcy are necessary to administer the code.

That is the position of the association, which represents more than 12,000 banks, mostly small banks, throughout the United States.

I would like to comment briefly on the consumer bankruptcy amendments. This association, as you know, Mr. Chairman, actively supported S. 2000, the bill reported by the subcommittee and the Judiciary Committee last session. The need for these reforms remains.

The level of bankruptcy in our area in the Midwest continues at about the same level that it has been in the past; substantially above the rate before the bankruptcy reform legislation was passed.

Time does not permit me to comment on each of the changes we support, but the thrust behind all the amendments is the same. Bankruptcy liquidation should be a last resort. The system and consumer bankruptcies should be redesigned to encourage individuals to deal honestly and fairly with their creditors and encourage individuals to make their best efforts to meet their obligations.

The system is not working that way now and should be changed.

In brief, that is the position of the American Bankers Association. Thank you for letting us appear, and thank you for taking up these important issues early in the term.

Senator **Dole**. As everyone knows, this did not pass last year because any one Senator could block it. I hope this year that whatever we may report and bring to the floor, if somebody wants to filibuster, why, that is fine. We will have the time to either invoke cloture or not, but it is an important issue that has to be addressed, as I see it.

Is it "Bell" or "Beall"?

Mr. **Beall**. It is pronounced "Bell." Donald Beall is my name and I am the manager of the NASA Federal Credit Union, Riverdale, Md. I have testified on several occasions and I think the consumer issues surrounding the Bankruptcy Reform Act of 1978 and the need for the changes are still there.

I would like to be brief and get to the real bankruptcy crisis we in the Credit Union National Association see.

A new crisis has arisen. In the *Marathon* decision the Supreme Court struck down the constitutionality of the court system, as we have all heard this morning.

I was also invited to participate in the conference held by Senator DeConcini. I am not a lawyer and not a judge, but I was concerned by what I heard. I heard that there was chaos in some of those courts.

As Mr. Creel pointed out in that hearing, there is serious concern about our bankruptcy court system, and I express that concern to you today on behalf of the Credit Union National Association.

We recognize that a bankruptcy court system must be able to resolve all bankruptcy-related questions. But, the question is how to quickly resolve the current crisis in the bankruptcy court system.

After the Marathon stay expired on December 24, a brief was filed by CUNA in the Supreme Court in *American Furniture* v. *Rivers* urging the Court to review its *Marathon* decision. It was our feeling that a court ruling on the constitutionality of the Judicial Conference's rules would eliminate future challenges to the authority of the bankruptcy courts under the rule pending full congressional review.

Although the Court declined to take the case, CUNA's participation remains a clear sign that we are ready to work toward a speedy solution to the crisis.

We urge the Senate to work quickly to resolve the crisis and bring bankruptcy administration to a steady course. The resolution to the *Marathon* issue is not incompatible with actions on the consumer bankruptcy provisions. Both are vital to the economy and the well-being of the Nation.

I do not believe it is necessary at this time to dwell on the specifics of the consumer bankruptcy amendments package that has been debated by this committee for more than 2 years. Previous testimony on these amendments is attached to the statement. I wish it made part of the record.

We are convinced that the work done in the last Congress on this package was sound. It is my personal feeling as well as that of the association that the resolution of the crisis in the bankruptcy court system and the adoption of the consumer bankruptcy amendments are critical to the Nation's ability to weather the current economic storm.

Again, I can only stress that I was concerned, sitting in Senator DeConcini's bankruptcy meeting, that there is a crisis and that the Congress must act quickly.

Senator DOLE. Thank you, Mr. Beall.

Mr. Klein.

Mr. KLEIN. Mr. Chairman, as requested, I will briefly summarize my statement and submit the entire statement for the record.

I am Raymond W. Klein, vice president, credit, R. H. Macy & Co., Inc., and I am pleased to appear today on behalf of the National Retail Merchants Association and American Retail Federation.

We wish to make it clear at the outset that passage of amendments to the Bankruptcy Code continues to be a high priority for retailing. From 1978 to 1981 consumer bankruptcies increased 165 percent, to 465,914. Although some of this increase can be attributed to high interest rates, inflation and unemployment, part of the increase is due to the fact that debtors can discharge all their debts even though they have the ability to repay a large portion of them.

The losses attributable to bankruptcy continue to mount at an alarming pace. Rather than burden my oral statement with this data, it is set forth at pages 3 and 4 of my prepared statement.

These losses precipitated a hard look by creditors at the financial circumstances of their customers who filed in bankruptcy. The traditional problems of unemployment, inflation, marital problems, large unexpected expenses, and overspending were found. But a new and substantial class of debtors, one different from the traditional debtor, has been found.

These persons were current on their required monthly payments, had little or no previous history of delinquency and some even had additional credit available on the account at the time the bankruptcy notice was received by the creditor. Certainly this debtor profile does not fit anyone's traditional notion of financial distress.

The massive increases in consumer bankruptcy experienced soon after the effective date of the act were not a temporary phenomenon. On the contrary, a very bad situation has continued and is getting worse.

Prompt action is necessary to address several problems in this area, two of which I will mention this morning. Others, of course, are addressed in my prepared text.

Our overriding concern, among a number of important issues, is the fact that a large number of debtors are able to have affordable debts discharged in bankruptcy. These are debts which could have been repaid from current earnings after providing necessary support for themselves and their families.

The Bankruptcy Code, however, adopts an antiquated assets-based approach to eligibility for relief. This approach fails to reflect the nature of today's consumer credit market, which is largely unsecured—at least insofar as open-end credit is concerned—and is predicated upon the consumer's willingness and ability to repay the debt out of income rather than from proceeds from the sale of assets.

The traditional balance sheet analysis of assets versus liabilities that is still prevalent for commercial transactions has given way to a system whereby credit is extended on the basis of capacity to repay, measured by only one asset—earnings potential—coupled with a review of the customer's payment history to gain some measure of willingness to repay.

It is essential that an equitable resolution of this problem be made an integral part of any legislative package of consumer bankruptcy amendments. Under our approach debtors in true financial distress would still be given the complete remedy of discharge. However, debtors able to repay a reasonable portion of their debts from anticipated earnings would be ineligible for chapter 7 relief.

This does not mean that the debtor will be left with no relief. Chapter 13 or nonprofit consumer credit counseling services would still be available to the debtor.

Turning to chapter 13, there are wide regional differences in the application of the new law to chapter 13 cases involving similar factual circumstances. We believe that the reason for this lack of uniformity stems from the absence of meaningful standards in key sections of chapter 13.

Section 1325 sets forth the standards governing the confirmation of a proposed plan. We recommend amending that section to provide, in addition to a requirement that the plan be proposed in good faith, a requirement that "the plan represents a bona fide effort which is consistent with a debtor's ability to repay his debts, after providing support for himself and his dependents. * * *"

In closing, there are a number of problems which we believe merit legislative attention in addition to those mentioned today. These include loading up, exemptions, reaffirmation, and the availability of the judge to counsel debtors, each of which is discussed in my prepared text.

We feel that all of these issues should be treated together because they are interrelated parts of the whole package of rights and duties in the field of consumer bankruptcy.

I thank you for this opportunity to express the views of retailing on this important subject. I will be glad to try to respond to any questions that the subcommittee may have, and if I am not able to supply the answers today, they will be furnished to the subcommittee for the record in the near future.

Senator DOLE. Thank you.

Senator Heflin?

Senator HEFLIN. Mr. Evans, can the raw data of the Purdue study be made available to the subcommittee?

Mr. EVANS. Yes, it can.

Senator HEFLIN. We spent a lot of time in this committee and the Judiciary Committee as a whole on S. 2000, and I think efforts were made to reach some sort of compromise relative to future earnings, and I really in all sincerity say that I think rather than compromise, it looks like battle lines have been drawn, and I think it has been explored on both sides, but there still might be that opportunity and you may want to pursue it.

What is the position of your various organizations pertaining to making bankruptcy judges under the present structure primarily, with some changes, article III judges, or, in effect, the Judicial Conference recommendation? Do you all have a position relative to these two issues?

Largely, the issue is, do you make presently a bankruptcy judge-type with some change of article III, or do you enlarge the district court? What is the position of your various organizations on this?

I understand Mr. Beall stated you had no endorsement position.

Mr. DIXON. The American Bankers Association supports article III bankruptcy judges.

Mr. EVANS. The coalition has not taken a position. The position we do espouse, however, is that we would like to see some resolution of the problem. The problem is probably somewhat overstated in the sense that we existed and worked this system for about 80 years, but all the deficiencies of that system are still with us and we agree that they should be resolved in some fashion. But beyond that, we have not.

I think it is very important that the proposed administrator does have a large bearing. This is something that has come out in recent months. It has a large bearing on our proposed consumer amendments, because obviously the consumer cases are mostly no-asset cases and would come before the Administrator.

We are deeply concerned about the quality of these administrators, the effectiveness and efficiency. Are they going to be just another bureaucracy that handles things when they feel like it, or not, and we don't want another Government welfare program for bankruptcies.

Senator **Heflin**. During the closing days you evidenced a feeling that bankruptcy problems ought to all be combined and handled in one bill, coming from your group. Is that your position relative to the posture of handling solutions to bankruptcy problems at the present time, and if so, why?

Mr. **Evans**. Let me answer that with a question.

If you had a severe problem in bankruptcy, as we think we do, upward to $1 to $1.5 billion a year being discharged, and that has got to be passed on to other consumers in higher prices, many of our creditors have altered their lending policies to exclude marginal borrowers from the marketplace.

In other words, they have gone into second mortgage and secured lending. As Congressman Gray said in the House, most of his constituents in Philadelphia do not have houses to offer as security for a loan, and they are going without.

Maybe in some people's view this is good, but we don't think so. It is distorting the economic marketplace, and we think it is having a great impact on the inability of our consumer to get back into consumer credit. So we think our problem is equally important, if not more so, to us and the economy and the consumer than the resolution of the judges problem, which, as I say, operated for 80 years under an article I procedure.

So, when Mr. Creel says to leave for some future time the resolution of our problem, we are not sympathetic. Whether it is having all the bills going out on the same train, as the lobbyists say, we are not enthused. This has not been considered in the House, and unless a package comes over from the House, we see very little chance to pass consumer bankruptcy legislation.

Senator **Dole**. I think we may have to address this strategy later. I think this is what it is, strategy. Of course, the pipeline case came along long after S. 2000 was hatched, so, obviously, it is sort of being held hostage by some who do not want anything to move unless everything moves.

I have been a part of that strategy, but if you do not have any votes on the House side, I might not remain part of that strategy. If you do not have enough votes to do something on the House side, we will have to bring both bills up and let the Senate work its will.

I assume that there will be some disagreements on both bills. You are sure to have some support in the House.

Mr. **Evans**. We had 280 cosponsors.

Senator **Dole**. Sometimes they do not vote that way. [Laughter.]

Mr. **Evans**. You are right. If the committee chairman does not wish to bring up legislation, it is difficult to get it considered.

Senator **Dole**. I have been having problems with my elevator bill. There are too many elevators in Newark. [Laughter.]

Mr. **Evans**. Let me say this just to put this in perspective. We tried to sit down a number of times, to sit down with the National Bankruptcy Conference, which seems to have—this is their turf—and others, to try to resolve this thing. We are not inflexible about the threshold problem. We are trying to seek a way in which the rough edges and concerns of the consumer groups can be taken care of, while still having meaningful relief in this area. We tried to compromise several times, but we found ourselves literally bargaining against ourselves. Until such time as everyone can sit down, it doesn't make sense proffering other types of threshold amendments.

Senator **Dole**. As I read some of the editorial comments, you get the feeling that what you really want is some legal way to harass creditors, or debtors, and it seems to me that that is not the case, but that is the perception, and you will be followed by another panel who may have that view, by Professor King, who thinks we should not do anything in this area. I have looked at his testimony. In the meantime, we are moving as quickly as we can to get this before the full committee, and, hopefully, the Senate floor.

Now, what action will take place there will depend a lot on what the strategy is, and so forth.

Senator **Heflin**. Mr. Klein, what is your position relative to structural problems, your preference for the American Retail Federation?

Mr. **Klein**. We are a member, and we submit our views to them, which they present for us.

Senator **Heflin**. You would have no position now?

Mr. **Klein**. No, sir.

Senator **Heflin**. Thank you.

Senator **Dole**. Thank you very much.

There was some reference, I think by Mr. Beall, some information to be made part of the record. Unless it is extensive, it will be made part of the record. It will be made part of the record by reference in any event.

Thank you.

[Material supplied by Messrs. Evans, Dixon, Beall, and Klein follows:]

Prepared Statement of Robert B. Evans

Mr. Chairman and Members of the Committee:

My name is Robert B. Evans. I am Senior Vice President and General Counsel of the National Consumer Finance Association (NCFA).* NCFA is a participant in the National Coalition for Bankruptcy Reform ("Bankruptcy Coalition") and is in agreement with its objectives. The Bankruptcy Coalition is an informal organization of members of the consumer credit industry, including retailers, oil companies, bankers, consumer finance companies and credit unions.

We welcome this opportunity to comment on the proposed amendments to the Bankruptcy Code provisions dealing with consumer petitions. Since the effective date of the Code the number of people declaring bankruptcy has risen dramatically. One of the causes of both the increase in the number of persons filing bankruptcy and the enormous losses being sustained by creditors, is the 1978 Bankruptcy Code.

The enactment of liberalized consumer bankruptcy provisions coincided with the advent of aggressive attorney advertising, inflation and other national economic problems, and a more tolerant public attitude toward those who declare bankruptcy.

While creditors cannot prevent people from filing bankruptcy, they can and do attempt to reduce their losses due to bankruptcy. This they are finding increasingly difficult to do.

This is because there are no characteristics, economic or other, that can be gleaned from consumer credit applications to predict in advance who might declare bankruptcy. Further analysis of more than 1,000 petitions reveals a very large portion of the debts listed, such as debts to relatives, friends, employers, doctors, etc., never appear on any credit report.

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*Organized in 1916, NCFA is the national trade association of companies engaged in the consumer credit business. NCFA represents over 580 companies with over 15,000 offices ranging from single, small loan offices to nationwide diversified non-bank financial services organizations engaged in unsecured direct lending, second mortgage lending and sales finance. In recognition of its diversifed membership, on February 1, 1983 NCFA will adopt the name American Financial Services Association.

If creditors could determine or predict which of their potential customers would file bankruptcy the solution to their problem would be obvious. But efforts to make such predictions have been unsuccessful. A customer's financial picture is often no different on the day he files bankruptcy than what it was when he was extended credit. Thus, efforts to reduce bankruptcy losses by further tightening of credit standards will not be successful. Even if creditors were to do so it would be at the expense of denying credit to entire classes of marginally qualified - but deserving - consumers.

Threshold Test

Personal bankruptcies rose dramatically almost immediately after the new Code became effective on October 1, 1979. Three years later they continue to run at an annual rate of about 450,000, or 200% of the rate for the 12 years prior to 1979. Although much of this increase is due to high interest rates, inflation, unemployment and lawyer advertising, it appears that many debtors have been counselled to seek discharge of all their debts in a straight Chapter 7 bankruptcy proceeding when they might easily have completed repayment of such debts under a court supervised plan under Chapter 13. Economic conditions cannot account for this class of bankruptcies.

In the 1981 study conducted by Purdue University's Credit Research Center it was estimated that of the $6 billion scheduled in bankruptcy that year, over $1 billion was unnecessarily discharged, i.e., could have been repaid by debtors without hardship.

During the 97th Congress, this Committee held two days of hearings on this subject, resulting in a provision that would direct the court, upon motion by any interested party, to consider a debtor's future income in determining whether or not the debtor qualifies for straight bankruptcy. The provision is based on the equitable premise that those who have the ability to pay out of future income should pay rather than pass their debts onto others.

A distinguished bankruptcy judge (now U.S. District Court Judge, Conrad Cyr) in 1975 testimony on the proposed Bankruptcy Code, said:

> "There is widespread awareness and acceptance of the basic rationale of our bankruptcy law that an honest debtor ought not be compelled to pay his debts when it would represent a real hardship for him to do so. But it is just as widespread an attitude that the shirking of just obligations should not be condoned by the law...
>
> One of the greatest needs facing the bankruptcy system today is a workable standard for determining the right to bankruptcy relief by deserving debtors."

Congress did not provide such a standard in 1978. As a result, about one person out of every four taking straight bankruptcy walks away from debts he could pay, transferring $1.5 billion in affordable debts to other consumers in the form of higher prices and interest costs. Even worse for some lower income consumers, it means curtailed access to credit.

No one seriously questions that debtors who can afford to pay, should pay. Why then, is there any resistance at all to a standard that would deny a discharge to a regularly employed debtor who has the disposable income to pay his debts?

It has been urged that some debtors who need a "fresh start" might be denied it. This concern is unwarranted. It is based on the mistaken notion that courts cannot fairly distinguish the deserving from the undeserving, those who cannot pay from those who can pay. But this is the function of courts, one that is exercised every day, both in the bankruptcy courts and elsewhere. Fairness and common sense dictate that the courts exercise this function; failure to do so would render our system of justice irrelevant.

The Bankruptcy Coalition supports the standard embraced in

S. 2000, the Bankruptcy Reform Act of 1982 as polled out of the Committee on the Judiciary during the 97th Congress. That bill established an equitable standard of relief - allowing those without ability to pay to discharge all their debts in straight bankruptcy - but leaving those with regular disposable income to pay their debts in a Chapter 13 repayment plan under court protection. That standard places a strict burden of proof on any party challenging the debtor's right to a discharge, and would enable the court to levy sanctions against any challenging party abusing the procedure.

Loading Up

One effect of the 1978 Bankruptcy Code is the loading up of consumer debt in contemplation of bankruptcy. This is of vital importance to the retail industry particularly as the bulk of retail credit is extended through open-end (revolving) credit plans. Often a debtor will go on a buying spree in contemplation of bankruptcy, knowing that he has no intention of ever paying for the goods.

The Bankruptcy Coalition favors an amendment to Section 523 of the Bankruptcy Code that would create a rebuttable presumption that any consumer debt incurred within 40 days before filing the petition is nondischargeable.

This provision will help alleviate the situation where a retailer, with no advance notice of a customer's insolvency, would not extend credit if he was aware of the customer's intention. Because most retail credit is unsecured, no security interest is retained in the merchandise. Thus, a retailer's sole remedy to loading up is to deny further credit. The amendment supported by the Coalition, in conjunction with the modification to the standard applicable to the award of attorney's fees in proceedings challenging dischargeability, would discourage this practice. Merchandise obtained by loading up is simply shoplifting with a credit card.

Reaffirmations

The 1978 Bankruptcy Code made sweeping changes to the reaffirmation provisions which existed under the old bankruptcy law. These changes were to correct improvident reaffirmations made by consumers in exchange for a small amount of new cash in a transaction reaffirming the original debt. The Code requires a three stage court approval process. First, the judge must explain reaffirmation; second, he must find the agreement is in the debtor's best interest and imposes no undue burden and third, the reaffirmation may be rescinded within thirty days.

Bankruptcy courts' interpretation of these requirements vary. Some courts categorically refuse all reaffirmation agreements, some provide a limited review and others approve reaffirmation agreements in mass at the discharge hearing. Generally the court will not approve a voluntary reaffirmation of an unsecured debt.

This has caused a serious impact on unsecured creditors. Credit unions in particular have been dramatically affected by this change. Traditionally, credit unions have always experienced a high rate of reaffirmation as their debtors are members of the credit union and as such have a cooperative interest in its ownership. Credit union members frequently approach the credit union after filing bankruptcy and attempt to make a voluntary reaffirmation only to have the court deny the requisite approval.

The Code also ignores the many valid reasons why a debtor may want to affirm a debt. The debt may be owed to a creditor from whom the debtor hopes to obtain service on credit in the future or be owed to a friend.

The Bankruptcy Coalition believes that the automatic stay provisions of Section 362 of the Bankruptcy Code eliminate the abusive practices which may have occurred under the pre-1978 bankruptcy law as creditors are now precluded from independently contacting debtors to encourage reaffirmation. The amendment sought by the Bankruptcy Coalition does not remove the protections against coercion but rather permits the voluntary, mutually agreed, reaffirmations presently being denied by courts to take place.

The Bankruptcy Coalition supports amending the Code to allow reaffirmation after the debtor has voluntarily initiated contact with the creditor concerning the debt, with rescission allowed anytime prior to discharge or within 60 days of the reaffirmation, whichever occurs later. This procedure would not require the debtor to return to court to secure reaffirmation, thus sparing both the debtor and the creditor the expense of counsel fees and additional court appearances. The reaffirmation agreement would simply be filed with the court with the present 30 day rescission period extended to 60 days to ensure that the debtor has an adequate opportunity to assess the impact of the reaffirmation.

Exemptions

Exemption laws are an essential element of bankruptcy relief. Prior to 1978 those laws were exclusively the province of the states. With the enactment of the 1978 Code, debtors for the first time had a choice between their state provided exemptions or a federal list of exempt property. Since that time, certain excesses have been found in the federal schedule which tend to encourage the filing of cases and which involve property that is not needed for the debtor's well being.

Three specific changes should be made in the exemption section of the Code.

First, the provision allowing joint petitioners to make separate elections to take advantage of the most liberal exemptions under both federal and state law should be eliminated. This provision allows married couples an unfair advantage over other debtors by allowing them to choose the most generous exemptions under both federal and state law. This inequity could be remedied by requiring joint petitioners to chose all of their exempt property under federal or state law, but not both. This is what individual petitioners do today.

Second, a monetary limit should be placed on the amount of household goods and furnishings, appliances, books and musical instruments that can be exempted. Currently, the debtor can exempt all such property that is held primarily for personal, family or household use as long as the value of any single item does not exceed $200 ($400 in the case of a joint petition). There is no limit on the amount of payments that may be exempted pursuant to this provision, thus allowing debtors to "stack" exemptions to maximize the total value of the exemptions.

We suggest that a limit be placed on this provision of $3,000. Debtors would continue to be able to exempt items of personal property up to a maximum of $3,000 in aggregate value.

Third, the "wild card" exemption should be eliminated. Section 522(d)(1) of the Code provides that a debtor may exempt an interest, not to exceed $7,500 ($15,000 in a joint petition) in value in real property. Section 522(d)(5) provides an additional exemption of $400 plus any unused portion of the real property exemption. If the debtor does not own real property or does not want to exempt it he may use this wild card to exempt an additional $7,900 ($15,800 in a joint petition) in any other type of property. This is in addition to the property exempted under the ten other subsections exempting property. This provision is unnecessary to the debtor's "fresh start" and should be eliminated. The right to exempt property in addition to that specifically listed in Section 522(d)(1) through (11) should be limited to $400.

Chapter 13

One of the principle objectives of the Bankruptcy Code was to increase the use of Chapter 13 by debtors encountering financial difficulty. A number of Chapter 13 provisions are designed to encourage debtors to enter a Chapter 13 repayment plan rather than use Chapter 7.

Such repayment plans work well in many jurisdictions, poorly in others, and not at all in quite a few. Part of the blame lies with the Code, part with the courts, but legislative improvements could cure most of the problem. The Bankruptcy Coalition believes that the Code should be amended to tailor payment plans to the debtor's ability to pay, both with respect to duration and amount. Since the maturities of many of todays consumer debts exceed 36 months, we believe it makes sense to expand the time during which the debtor may make repayment. Longer repayment periods would also give the debtor more time in which to repay debts. Other recommendations include requiring the debtor to make payments to the Chapter 13 trustee within 30 days of filing the plan rather than waiting several months until the plan is confirmed. The Bankruptcy Coalition supports the parallel treatment between nondischargeable claims in both Chapters 13 and 7, and believes that the provision which forbids modification of real estate mortgages on a principle residence should apply to all loans fully secured by real property.

Preferences

Section 547 provides that a debtor's payment on an unsecured debt may be recovered by the trustee from the creditor if it was made within 90 days before the bankruptcy petition was filed. This includes such things as routine periodic payments on charge accounts even if the creditor has not in any way encouraged the payment. Such payments were also returnable under the Bankruptcy Act, but only if the creditor had reason to know the debtor was insolvent. That test should have been preserved under the Code.

The purpose of a preference law has always been to promote equality among creditors and to deter creditors from applying last minute pressure on a debtor in the hope of obtaining more of the debtor's assets than they would receive in bankruptcy. In the case of routine payments on consumer accounts, Section 547 accomplishes neither result. Other creditors are not benefited by this section since little if any of the recovered payments are left to distribute after the administrative costs and collection costs are paid. Furthermore, debtors are not helped since ordinary course payments are by definition made without pressure.

Thus, the present provision imposes a considerable cost on some creditors with no corresponding benefit to other creditors or to debtors. The prior law should be reenacted, creditors who receive ordinary periodic payments prior to the filing of a bankruptcy petition should be allowed to retain those payments unless they had reasonable cause to believe the debtor was insolvent at the time they received the payment.

Avoidance of Nonpurchase Money Security Interests

Section 522(f)(2) of the Code permits a consumer debtor to invalidate non-possessory, nonpurchase money security interests in household goods, personal articles and tool of the trade. The purpose of the section is to preserve property which is necessary for the debtor's "fresh start." That fresh start would be impaired if the debtor had to pay the full amount of the debt to retain goods which were necessary for minimal living standards and which had a high replacement cost. The present provision is a classic example of overkill. The provision recognizes the debtor's need for the goods, and makes the unwarranted assumption that if the security interest is valid, the debtor will lose the goods, and then invalidates the security interest *in toto* to avoid such a result. Such a scheme creates a serious imbalance in the rights of debtors and creditors. Moreover, it effectively precludes creditors from making loans secured by such articles since the security interest will not be valid in bankruptcy. The result is either severe economic loss to the creditor or deprivations of the consumer's ability to use his own property as security.

This provision works particularly to the disadvantage of lower income groups. Minority and other lower income groups do not as a general rule enjoy the same advantages of home ownership as do others. For them the availablity of unsecured credit is a must, or they do without.

The rights of the debtors and creditors can be better balanced, and the objective of Congress enabling the debtor to retain property necessary for a fresh start can be preserved, without the punitive provision now in the Code. Rather than invalidating the security interest entirely, the debtor should be permitted to redeem the property over a reasonable period of time. The redemption price will be determined by the market price. This approach is consistent with the expectation of both the consumer and the creditor that the consumer will pay for goods out of future income and not the proceeds of sale. Moreover, it is consistent with the consumer's desire to redeem the property.

Conclusion

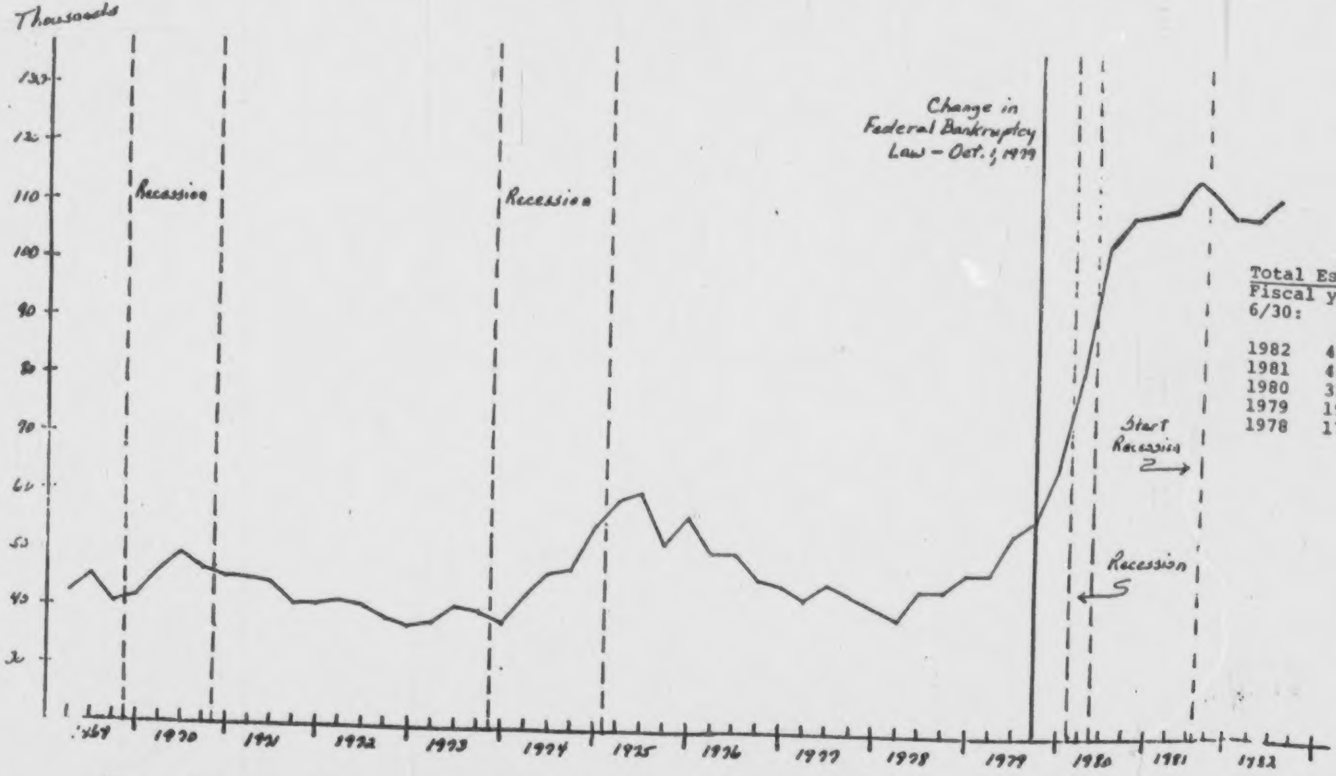
The Bankruptcy Coalition commends the Members of the Senate Committee on the Judiciary and the Subcommittee on Courts for the attention and assistance rendered in seeking a legislative solution to this important problem. We appreciate the opportunity to present our views on this issue.

Supplements

1. Chart of Personal Bankruptcies 1969-1982.
2. Chart of Bankruptcy Filings per 1000 Households and Consumer Installment Credit Outstanding in 1972 Dollars per Household.
3. Table comparing Chapter 13 filings in 5 lowest states with 5 highest states.

Exhibit 1

Personal Bankruptcies
Quarterly, 1Q1969 - 2Q1982

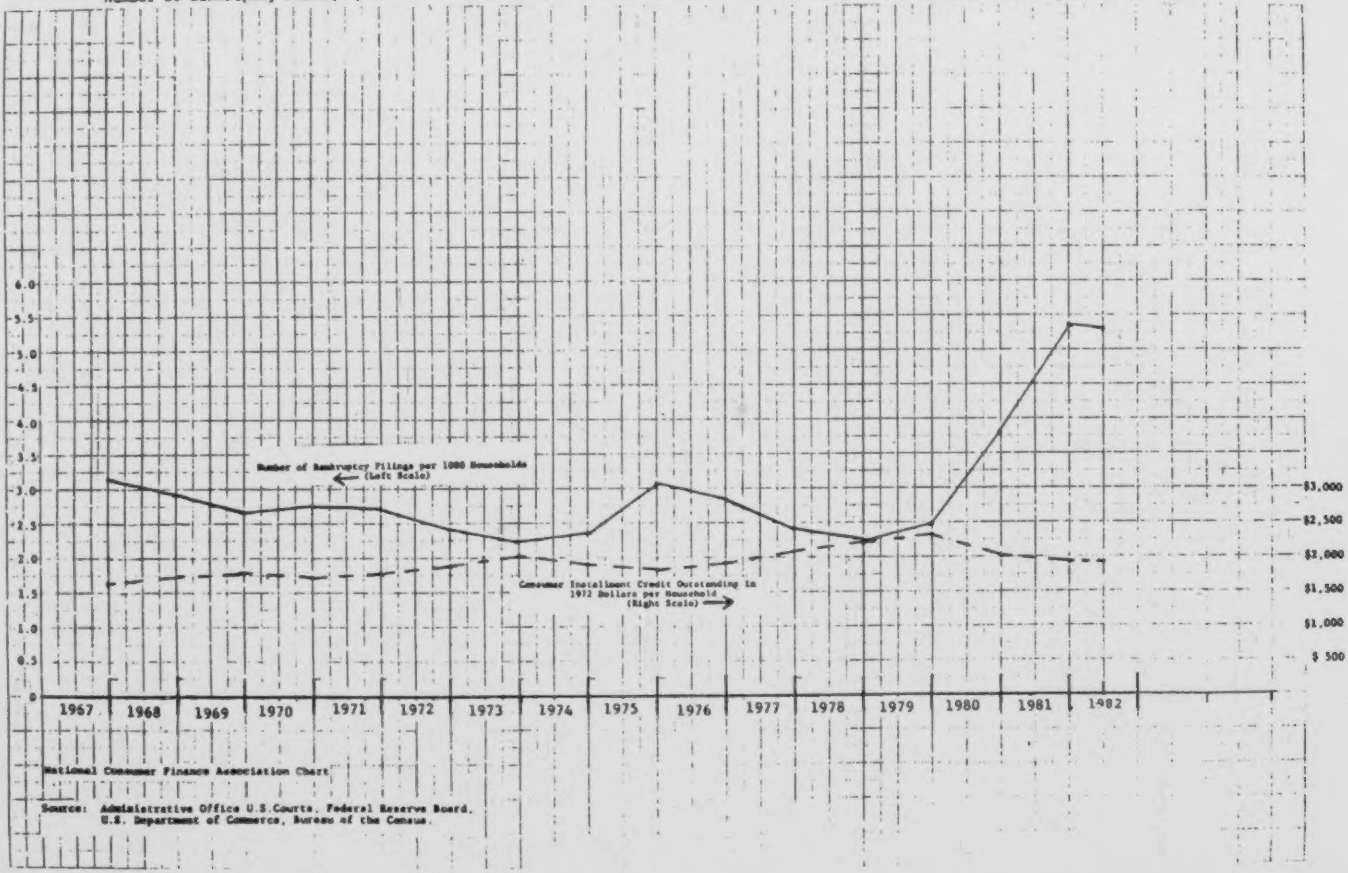


Total Estates Fiscal year ending 6/30:	
1982	449,839
1981	449,645
1980	314,875
1979	196,976
1978	172,423

Source: Bankruptcy Division, Administrative Office of the U.S. Courts

Exhibit 2

Number of Bankruptcy Filings per 1000 Households and Consumer Installment Credit Outstanding in 1972 Dollars per Household



National Consumer Finance Association Chart

Source: Administrative Office U.S.Courts, Federal Reserve Board, U.S. Department of Commerce, Bureau of the Census.

Exhibit 3

INDIVIDUAL BANKRUPTCY FILINGS (JULY 1981 - JUNE 1982)

Bankruptcy filings under Chapter 13 as a percentage of total non-business filings. (Five states with the smallest percentage vs. the five states with the largest percentage.)

	Nonbusiness filings (includes joint petition)	Chapter 7	Chapter 13	Chapter 13 as a percent of Nonbusiness filings*
West Virginia	2,983	2,804	169	5.67%
Indiana	17,207	15,864	1,263	7.34%
Iowa	4,072	3,719	309	7.59%
Nevada	3,002	2,720	242	8.06%
Arizona	5,257	4,785	435	8.27%
				7.38% avg.
Tennessee	18,230	9,485	8,665	47.53%
South Carolina	2,826	1,287	1,525	53.96%
Arkansas	3,561	1,301	2,228	62.57%
Alabama	13,270	4,871	8,359	62.99%
North Carolina	9,431	2,819	6,569	69.65%
				59.9 % avg.

* 30% of all individual nonbusiness filings throughout the U.S. in 1981-82 were Chapter 13. The highest percentage - 84% - was filed in the Middle District of North Carolina.

Credit
Research
Center

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Consumers' Right to Bankruptcy
Origins and Effects

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Krannert Graduate School of Management – Purdue University

CONSUMER BANKRUPTCY STUDY

VOLUME I

Consumers' Right to Bankruptcy: Origins and Effects

CREDIT RESEARCH CENTER
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CHAPTER 2

SAMPLING DESIGN AND INTERVIEW PROCEDURES

Blair Shick, Esq.*

The data for the research were drawn from personal interview responses of 1,199 Chapter 7 individual (nonbusiness) bankruptcy petitioners. Related data bases included information from the petitions filed by those interviewed, from the credit reports of interviews who authorized their release, and from the petitions of those who declined the request to participate in the interview.

The survey base consisted of approximately sixty petitioners from each of 20 federal judicial districts. To establish this sample, two judicial districts were selected from each of ten states. The petitioners interviewed were selected from the examination calendars for 91 different hearing sites under the jurisdiction of 47 different bankruptcy courts within the 20 districts.

This chapter describes the criteria used for the sampling design and the procedures followed in preparation and execution of the interview program and in establishment of the related data bases.

I. Basis for Selection of States and Judicial Districts

A major objective of the research was to compare and contrast the characteristics of bankruptcies among states with differing levels of exempt property--property that the debtor is allowed to retain without being sold to satisfy debts. This led to a search for states with differing exempt property laws. Another objective was to assess evidence of differences among bankruptcies within a given state.

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*Arthur D. Little, Inc.

A. States with Two or More Federal Judicial Districts

The federal judicial system is organized in units of judicial districts. Every district is confined to a single state. In some states the judicial district comprises the entire state. Other states have more than one district, each covering a different geographic area in the state. California, New York and Texas, for example, have four federal judicial districts each. Each district has a single U.S. District Court.

The bankruptcy courts are separate departments of the U.S. District Court, but will become adjuncts April 1, 1984. Bankruptcy-related data are collected and reported by the entire district. In fact, the administration of the bankruptcy system is somewhat more decentralized. Bankruptcy Judges[1] and the related clerical staff maintain separate jurisdictions within districts, organized in terms of counties or parishes, that are responsible for the conduct of the bankruptcy proceedings in that area. However, the availability of uniform data for each district argued for the organization of the research design along existing district lines.

Thus, to provide the opportunity to test for differences in bankruptcy profiles within a state, it was determined that only states with two or more districts would be included in the sampling base. Two districts were to be selected in each of ten states with 60 interviews to be conducted in each district, for a total of 120 per state.

B. Differences in Exempt Property Law

Prior to the 1978 revision of the bankruptcy laws, the determination of the property to be exempt in bankruptcy was governed by state law only. The new Bankruptcy Code established a set of federal standards for exempt property and gave the bankrupt petitioner the option to select either state or federal exemptions standards to govern his or her property in bankruptcy. However, Section 522(b)(1) of the new Code also allowed a state to restrict its citizens to the use of state exempt property standards by legislation specifically denying authorization to use the federal standards. Since the federal standards were perceived to be higher or different from local standards of perceived need in one respect or another,[2] some 15 states had enacted legislation of this kind effective on or about January 1, 1981 (Exhibit 2-1).

EXHIBIT 2-1

STATES WITH EXCLUSIVE EXEMPT PROPERTY STANDARDS*

Alabama
Arizona
Florida
Georgia
Illinois
Indiana
Kansas
Kentucky
Louisiana
Nebraska
Ohio
South Dakota
Tennessee
Virginia
Wyoming

*Effective on or before January 1, 1981.

The existence of 15 states with exempt property standards independent of the federal law provided the opportunity to isolate a group of these states for comparision with states where petitioners had the option to select the federal or higher state standards. The decision was to constitute the ten-state sample with five low-exemption and five high-exemption states.

1. Selection of low-exemption states

The legislation of the 15 states listed in Exhibit 2-1--those which had effective laws to deny the use of federal exemptions--was examined to assure that their exempt property standards were in fact lower than those in the Bankruptcy Code. A few states, e.g., Arizona, Florida, and Kansas, were eliminated since their homestead exemptions were much higher than the federal, even though their personal property standards were comparable or lower.

The states remaining with low-exempt property standards were then tested against the criterion established calling for two or more judicial districts. In turn, the makeup of each district was analyzed, together with the data on bankruptcy filings in the prior year (July 1, 1979 through June 30, 1980) to assure that adequate numbers of petitioners could be expected to meet the target of 60 interviews within an approximate three-month period. Through this process, the states and districts indicated in Exhibit 2-2 were selected as the sampling base for low-exemption states where interviews were to be conducted.

2. Selection of high-exemption states

The next task was to select five other states where at least federal exempt property standards were applicable. Inquiry with lawyers knowledgeable in personal bankruptcy confirmed that no single state could be identified as having standards that would be consistently higher in all property categories than those in the new Bankruptcy Code. California and Texas were identified as states that stood out as having high standards for particularly important property such as residential or household property. This left a range of choices for other states in the high-exemption component of the survey sample.

A major concern in the selection process was to assure that both the economic base and the urban/rural mix of the states and districts selected were substantially similar to that for the low-exemption states. In addition, there was the criterion that two judicial districts be included in each state and that adequate volumes of bankruptcies exist to yield the necessary interviews. The analysis resulted in the selection of the states and districts listed in Exhibit 2-3 as the high-exemption component of the survey base.

II. Field Investigation And Preparation

A. Arrangement for Personal Interviews

Experience with individual survey techniques indicates that spontaneity and thoroughness of response are best achieved by personal interviews conducted in the context of the event or circumstances that are the subject of the research. This criterion indicated that a personal interview should be administered at some time during the bankruptcy process--subsequent to the petition filing, but prior to the final discharge. The optimal time seemed to be in the context of a court proceeding, when the subject matter was fresh in the mind of the respondent. In the average case, this would also mean the respondent's attorney might be present--a fact that would lend comfort to the respondent during the interview process.

EXHIBIT 2-2

LOW-EXEMPTION STATES IN SURVEY BASE

State	Exempt Property Standards	Districts
Georgia	$200 in each household item; $5,000 homestead (head of household only)	Northern Middle
Illinois	$1,000 total in personal property; $10,000 homestead (one spouse only)	Northern Central
Louisiana	Specified furniture only; $15,000 homestead (one spouse only)	Eastern Western
Ohio	$200 in each household item; $5,000 homestead (both may claim)	Northern Southern
Virginia	$3,500 total in personal property $5,000 homestead (one spouse only)	Eastern Western

EXHIBIT 2-3

HIGH EXEMPTION STATES IN SURVEY BASE

State	Districts
California	Northern Central
New York	Northern Western
Pennsylvania	Middle Western
Texas	Northern Western
Wisconsin	Eastern Western

B. The 341 Examination

Under the new Bankruptcy Code, the average consumer Chapter 7 petitioner makes two in-court appearances after the filing of the petition. The first is mandated by Section 341 of the Code, which requires a meeting of creditors where the debtor is required to appear and be examined under oath.[3] The court is not permitted to attend this hearing, which is administered by a bankruptcy trustee or a U.S. Trustee in certain districts. In the typical case, a trustee appointed by a court examines the debtor who, in turn, can be questioned by the creditors.

The second appearance is the discharge or final hearing which, for most purposes, mark the termination of the Chapter 7 bankruptcy proceeding. This hearing is presided over by the court (the bankruptcy Judge). But, due to the rapidly increasing numbers of bankruptcy cases, many Judges had abandoned the notion of individualized hearings and were using a group proceeding, consisting of a number of debtors scheduled to appear simultaneously. This meant that intercept interviews would be difficult to administer at that time. In addition, it was considered that the psychological effect of the finality of the discharge might bias interview responses at this time.

Thus, it was determined that the 341 examination period presented the best opportunity to conduct the interview.

C. Preinterview Contacts and Data Analysis

A mailing summarizing the research project was forwarded to each bankruptcy Judge in the states and districts selected for the survey base (Appendix A). This was followed by phone contacts to the chief bankruptcy Judge[4] in each district to arrange personal interviews with the court and appropriate representatives of the clerk's office. In most cases, personal contacts were made with the senior bankruptcy Judge assigned to different geographic areas within the districts. Personal arrangements were required by the considerable variation in administration and scheduling of the 341 examinations in the different areas.

The purpose of the visits was to acquaint the different judges with the study, to learn scheduling practices in the different areas, to inspect the hearing sites used for suitability for interviews, to obtain data on the numbers of petitions and hearings in prior reporting periods, and to arrange for advance communication to attorneys and trustees concerning the research and interview program.

The case load experience in the prior year was used to assign interview quotas for each hearing location. For example, if one geographic area within the district had jurisdiction over one-third of the Chapter 7 petitioners in the prior year, that area was scheduled to produce 20 of the 60 interviews administered in that district. The interview schedule was further broken down pro rata where two or more hearing sites (for residents of designated counties) were regularly used within the same area. The intent was to obtain representation in the survey base that was proportional to the actual experience district-wide.

III. The Interview Process

A. Pretest of Questionnaire

During the planning stages, a survey instrument was drafted and edited by the different members of the research team. A testing exercise was conducted in the bankruptcy court of Judge Ralph H. Kelly, Chattanooga, in the Eastern District of Tennessee. The draft questionnaire was administered to 20 Chapter 7 petitioners by research team members and professional interviewers. Based on the experience, appropriate revisions were made. A copy of the questionnaire is reprinted in Appendix A. The estimated completion time for the interview was 20 to 22 minutes.

B. Period of Interviews

The interviews were conducted during the period of May 20 through August 2, 1981. Because of variations in the scheduling frequency of 341 examinations--due to case load and geography--the 60 interviews were completed in some districts before those in others. In general, the bulk of the interviews was administered during June and July.

C. Interview Procedure

All of the 1,199 interviews were conducted by professional interviewers who were residents of the state or district in which the interviews were administered. Over 90 percent of the interviews were conducted at the site of the 341 examination location. Most were administered after the respondents were finished with their formal examination. In some cases, the interviews took place in the same hour but prior to the examination. The interviewer contacted petitioners individually in order to introduce the research program and seek the cooperation to participate in the interview. Attorneys accompanying the petitioner were extended the opportunity to examine the questionnaire and to be present during the interview. In 144 instances, the attorneys were present. If a person declined to participate, the next petitioner scheduled for examination was approached. Altogether, there were 1,050 refusals to the request for the participation in the interview.

A total of 106 interviews were administered in person at locations other than the hearing site--usually in the petitioner's home. Those interviews were all after the 341 examination. The off-site interview procedure was adopted at the request of bankruptcy Judges who were concerned that any on-site arrangement gave an appearance of court sanction or sponsorship. The procedure was to telephone the petitioner and make arrangements for the personal administration of the interview at a convenient location.

D. Selection of Interview Respondents

The bankruptcy petitioners requested to participate in the interview were selected on the basis of strict hourly and daily quotas established for each 341 examination site. As a general rule, examinations are scheduled on the basis of six to eight petitioners each hour. Depending on the volume of cases for a particular hearing site, the calendar might run anywhere from two to six hours per day.

A maximum of two interviews per hour was established, with the interviews to continue on a given day until the daily quota was reached. The daily quota was determined by comparing the number of petitioners typically scheduled in a day with the overall quota for interviews from that particular site. To illustrate this process, assume a 341 examination location that represented one-third of the Chapter 7 individual bankruptcy petitions heard in the district in the prior judicial year; 20 of the 60 interviews for the district were planned to be conducted at that location. If examinations were scheduled twice monthly at that location--on a half-day basis with an average of 18 petitioners scheduled over a three-hour period--a daily quota of seven interviews was established. The interviews were then administered during the first three successive examination dates scheduled for the particular location following the May 20 start day.

If the first two petitioners contacted in a scheduled hour agreed to participate, the hourly maximum of two interviews was reached and no more interviews were requested of petitioners scheduled for that hour. If an hourly quota was not reached, the daily quota was reduced by that amount and the shortfall in the target established for that particular hearing location was reached by interview(s) conducted during the next scheduled examination date following those planned to fulfill the target. This same procedure was used for selection of participants where off-site interviews were conducted.

IV. Other Data Bases

A. Data From Petitioners

After the interviews were completed, the interviewers obtained the petitions filed with the court by each person requested to participate in the interview. The petitions are required to be filed to commence a bankruptcy proceeding and contain information on assets, property declared as exempt, debts, creditors, and the like. Certain data elements were removed from each petition, coded and entered into the data bases established from the interview responses. A copy of a petition code form is shown in Appendix B.

The petitions copied included those for persons who declined to be interviewed. The same data elements were removed from these petitions. The objective was to establish a framework for comparison between those who agreed to be interviewed and those who did not.

B. Credit Report

A final set of data collected for the research analysis included that from the credit reports of the petitioners who participated in the interview and authorized the release of their credit report. Authorization to obtain a copy of the report was requested at the end of each interview. The form for the authorization is in the questionnaire in Appendix A. Altogether, 912 of the 1,199 interview respondents provided the authorization requested.

FOOTNOTES

[1] Due to the highly technical nature of bankruptcy, a specialized judiciary is maintained. Bankruptcy Judges are separate from the U.S. District Judges. They are appointed by the President, with the advice and consent of the Senate, and serve a term of 14 years. See 28, U.S.C.A. Sections 151-153.

[2] The Bankruptcy Code exempts, among other property, up to $7,500 in residential property, up to $1,200 in a motor vehicle, up to $200 in any particular item of household goods, clothing and noncommercial animals,up to $500 in personal jewelry, unmatured life insurance values, health aids, and up to $400 (plus any unused amount in the residential property exemption) in any property. See 11 U.S.C.A. Section 522(d).

[3] See 11 U.S.C.A. Sections 341 and 343.

[4] The bankruptcy Judge with seniority in commission in active service, 28 U.S.C.A. Section 155.

CHAPTER 3

BANKRUPT DEBTORS' ABILITY TO REPAY DEBTS

Richard L. Peterson*

I. Overview

The major objective of this chapter is to determine the proportion of their debts that consumers who had filed for Chapter 7 could have repaid out of future income. Estimates are provided to show the percentage of consumers who could have repaid all or a major portion of their nonmortgage debts out of future income. The percentage of consumers who could have repaid their debts out of nonexempt asset holdings is also calculated. In making calculations of consumers' ability to repay out of income, it is assumed that debtors would retain their present income level, keep their current residences, and repay their debts out of income remaining after providing for taxes, housing and utility expenses, necessary child care, alimony (when applicable), extraordinary medical care or child support expenses, and basic (nonhousing) living expenses.

The chapter is organized as follows. Section II presents data on the income and employment status of debtors' who filed for relief under Chapter 7 of the U.S. Bankruptcy Code. It also explains how after-tax income was calculated from information provided by the debtors. Section III explains how individual debtors' "basic living expenses" were estimated. Section IV then shows how income available to repay debts was calculated, while section V presents tables that show (1) the percentage of bankrupt debtors who could have used their available income to repay their debts, other than mortgage and business debts, in full, over different periods of time and (2) the percentages of their total debts that individual debtors could have liquidated at different points in time. Section V also looks at the income and ethnic characteristics of those who could or could not have repaid their debts. Finally, section VI analyzes consumers' abilities to repay debts out of assets rather than income and section VII summarizes the major findings of the chapter. Following section VII, the Appendix uses data obtained from bankruptcy petitions to compare asset, income and debt characteristics of both respondents and nonrespondents to the bankruptcy survey.

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*This chapter was prepared with the assistance of D. A. Black and S. Badrinath. Robert W. Johnson provided many helpful suggestions.

II. Computation of After-Tax Income

A. Present and Expected Income

Several sources of income data were available in this study. The primary source was data obtained from respondents' answers to the set of questions presented in Exhibit 3-1. The secondary source of data on income was the bankruptcy petition. All people who file for bankruptcy are required to report their income for each of the two previous years on the bankruptcy petition.

Additional information was also obtained from all respondents on their present employment status, their employment status in the previous 12 months, and their expected level of income at year-end. That information is summarized in Exhibit 3-2.

The data presented in Exhibit 3-2 indicate that the majority of the bankruptcy filings were made by petitioners who were fully employed and had been fully employed for the previous year. Furthermore, the vast majority expected their income either to increase or to remain the same for at least the next six months. Based on their stable employment and optimistic income expectations, we felt it was reasonable to expect that most petitioners' current income levels would be maintained in the future.

EXHIBIT 3-1

QUESTIONS RELATING TO TAXABLE AND NONTAXABLE INCOME

45a. Have you received any food stamps in the past month?	1 YES 2 NO → SKIP TO Q. 46 x y
IF "YES", ASK: 45b. What was the total value of the food stamps you received last month?	$____ 0 DON'T KNOW x y
46. How much was your family's total income last month from nontaxable sources, such as social security, child support payments, unemployment or workmen's compensation, and welfare? (IF RESPONDENT IS NOT SURE, ASK FOR BEST ESTIMATE.)	$____ 0 NONE 9 DON'T KNOW x y
47. And, how much was your total family income before taxes from all taxable sources last month? (IF RESPONDENT IS NOT SURE, ASK FOR BEST ESTIMATE).	$____ 0 NONE 9 DON'T KNOW x y
48. By December of this year, how likely is it that your total monthly income from all sources will be higher or lower than it was last month? Would you say that it will definitely be higher, probably be higher, probably be lower, definitely be lower, or will it be about the same?	1 DEFINITELY HIGHER 2 PROBABLY HIGHER 3 PROBABLY LOWER 4 DEFINITELY LOWER 5 ABOUT THE SAME 6 DON'T KNOW x y
IF "HIGHER" OR "LOWER" ON Q. 48, ASK: 49. Do you expect that (increase) (decrease) will be 10% or less or will it be over 10%?	1 10% OR LESS 2 OVER 10% 3 DON'T KNOW x y

SOURCE: Credit Research Center, Purdue University, Consumer Bankruptcy Study.

EXHIBIT 3-2

EMPLOYMENT STATUS, RECENT EMPLOYMENT STATUS, AND EXPECTED FUTURE INCOME OF SURVEY RESPONDENTS

I. Full-Time Employment Status: By Petition

Type of Petition		One Person Employed Full-Time	Two People Employed Full-Time	At Least One Person Employed Full-Time
Single filing (626)		471 (75.2%)	XXXX	471 (75.2%)
Joint filing (571)		345 (60.4%)	124 (21.7%)	469 (82.1%)
Unknown (2)				2 (100%)
Total	1,199	816	124	942 (78.6%)

II. Full-Time Workers Employed Continuously for the Previous Year

If One Person Employed Full-Time	If Two People Employed Full-Time	Total
596 (73%)	106 (85.5%)	708 (76.6%)

Thus, over 76.6 percent of full-time workers (58.5 percent of the sample of 1,199) had been employed continuously for the previous year.

III. Employment Status: By Sex of Respondent (percentage distribution)

	Male	Female
Employed full-time	72%	41%
Employed part-time	5	11
Not employed	20	45
No answer	3	3

IV. Employment Status for Previous 12 Months (percentage distribution)

	Male	Female
No answer	4%	12%
None	8	25
1-5 months	13	12
6-8 months	14	9
9-11 months	12	10
All 12 months*	49	32

*Males employed all 12 months totaled 489, and females totaled 322.

EXHIBIT 3-2--Continued

V. Expected Income at Year-End will be	
Definitely higher	24%
Probably higher	26
Same	35
Don't know	5
Probably lower	6
Definitely lower	4

SOURCE: Credit Research Center, Purdue University, Consumer Bankruptcy Study.

Further, we felt that such an assumption might well be conservative since a large proportion (50%) of the respondents expected that their incomes would soon rise. Consequently, we based our estimates of petitioners' future income levels on their present income levels.

B. Computation of After-Tax Income

Calculations of after-tax income were ordinarily made from data on income, dependents, alimony payments, child care expenses and marital status that were provided on the questionnaire. In addition, data on property taxes and medical payments were used in tax calculations if the sum of these two items exceeded the standard deduction. Most tax calculations assumed that the respondent took the standard deduction and earned income subject to social security taxes. Insofar as respondents were able to itemize deductions, their Federal tax liability was overstated and their after-tax income was understated. Assumptions regarding applicable tax tables and the portion of income subject to social security tax also had the effect of overstating Federal taxes and understating after-tax income. Thus, in general, most estimates of after-tax income were too low, if only Federal taxes were considered. However, since state income tax liabilities were not taken into account, on balance, after-tax income estimates were deemed to be approximately correct.

The calculation of after-tax income required several steps: (1) determination of taxable income, (2) determination of social security taxes, (3) determination of marital status and appropriate tax tables, (4) adjustments for alimony and, if applicable, deductible medical and property tax outlays, (5) calculation of Federal tax liabilities, (6) adjustments for child care credits, (7) adjustments in income to allow for alimony payments, social security taxes, Federal taxes net of child care credits, and the receipt of nontaxable income flows.

After-tax income is the amount of income remaining after each of these adjustments has been made. Each adjustment is explained in more detail below.

1. Determination of Taxable Income

Whenever possible, present taxable income levels were estimated from information obtained in response to question 47 (Exhibit 3-1). That figure was multiplied by 12 to obtain an estimate of their annual taxable income, and was compared to previous year's income reported on the petition. Unless there were wide discrepancies in the two figures, the questionnaire data were used as an estimate of taxable annual income.

However, in some cases respondents did not provide such data, or provided estimates of their income that diverged widely from the previous years' income levels they had reported on their petition. If respondents did not answer question 47 ("none" and "zero" were both considered answers), 1980 income (as reported on the petition) was used as an estimate of taxable income. Also, if income data reported on the questionnaire exceeded 1980 income levels by 33 percent or more, 1980 petition data were used to estimate taxable income. The 33 percent standard was used to eliminate reporting errors. It may also have eliminated some truly large income increases. For instance, a spouse may have taken a new job. However, such errors were deemed unavoidable since our objective was to prevent overestimates of income from being made.

Finally, if the petition data exceeded the income level reported on the questionnaire by more than 33 percent, a possible income understatement was flagged. Such understatements could have reflected either reporting errors or the reporting of take-home pay rather than taxable income. Because of the 33 percent criterion, the erroneous reporting of take-home pay frequently would not be caught (e.g., it would not be caught if less than 33 percent of the paycheck were withheld). However, the 33 percent allowance was necessary in case hours worked declined (due to less overtime or other factors).

When a 33 percent or greater drop in income was flagged, additional checks were made to see if there was some reason for the large income decline. These checks consisted of a scan of the reasons reported for filing bankruptcy (see Exhibit 3-3).

If the respondent cited a personal, employment, or business-related problem as a reason for filing, the reported decline in income was assumed to be accurate and questionnaire data were used to estimate taxable income. If the respondent reported only credit-related reasons for bankruptcy, then it appeared unlikely that income had declined substantially. In that case, 1980 income data were used to estimate the respondents' taxable income.

In estimating taxable income, only conservative assumptions were made. Thus, no allowance was made for possible income growth, even when 1980 income data were used or respondents said their future income would definitely rise. Also, large increases in income were disallowed automatically while only implausible large decreases in income were

EXHIBIT 3-3

REASONS FOR FILING BANKRUPTCY

Reason Cited (Multiple Responses Allowed)	Percentage of Respondents Saying the Reason Was Important	One of the Most Important
I. Personal reasons		
A. Medical bills (doctors, hospitals)	43*	15
B. Marital problems (divorce, separation, alimony, child support)	28*	12
C. Natural disasters (floods, hurricanes)	2*	1
D. Death in the family	4*	1
E. Addiction or dependency (drugs, gambling, alcohol)	3*	1
II. Employment or business problems		
A. Cutback in hours worked	17*	5
B. Laid off or fired from work	27*	12
C. Own business failed	15*	7
D. Employer's business failed	5*	2
E. Unable to work due to accident/illness	21*	7
F. Lost second income	16*	4
III. Credit/financial problems		
A. Bought too much on credit	44	14
B. Credit was too easy to get	28	4
C. Unable to get creditors to extend loans or agree to different payment schedule	21	4
D. Creditors tried to collect their money	29	4
E. Sued by creditors	23	5
F. Wages actually garnished	13	4
G. Some property repossessed	10	1
H. Cosigned on loan that was not paid	6	1
I. Cost of living went up	45	8
J. Other(s)	19	9

*If any one of these reasons were cited as important factors in bankruptcy filings, large declines in income were taken as valid estimates of expected taxable income.

NOTE: Totals add to much more than 100 percent because of multiple responses.

SOURCE: Credit Research Center, Purdue University, Consumer Bankruptcy Study.

disallowed. Finally, many consumers may have reported take-home pay rather than taxable income. As a result it is likely that pretax income was understated in many cases. Respondents' taxable income averaged $10,409. In contrast respondents' average 1980 income, as reported on petitions, was $13,979.

2. Determination of Marital Status and Appropriate Tax Tables

The information provided by respondents on their marital status was used to determine the appropriate Federal income tax tables for calendar year 1980. In particular, single respondents were assumed to use tax table X, married respondents were assumed to use the version of tax table Y that applied to married couples filing jointly, and separated respondents were assumed to use the version of tax table Y that applied to married couples filing separately. Respondents who were divorced, widowed, or living as married were assumed to use tax table X unless they had dependents. If they had dependents they were assumed to use tax table Z for head of households. If the respondent's marital status was unknown, tax table X (for single persons) was used; if anything, that procedure would overstate their potential tax liabilities.

In general, the assignment of tax tables was made so tax liabilities would be overstated rather than understated if critical information was missing. In addition to people for whom marital status was unknown, possible overstatements were made for recent widows and widowers--who are eligible to use joint tax tables for several years--and for separated people who may have filed jointly rather than separately. Also, because 1980 tax tables were used and taxes were cut in 1981, some small overstatements of tax liabilities may have resulted from that source.

3. Adjustments for Alimony and Large Deductions

Monthly alimony payments reported on the questionnaire were multiplied by twelve and subtracted from taxable income. Also, to the extent that the sum of property tax payments plus medical expenses exceeded the standard deduction applicable to a person with the respondent's filing status, the excess deductions were also subtracted from taxable income.

4. Calculation of Federal Tax Liabilities

The number of dependents times $1,000 was also subtracted from taxable income for each respondent. Then the income tax liability was calculated by referencing the appropriate tax table (X, Y, Z, etc., as described previously). The tax tables automatically allowed each taxpayer to take the appropriate standard deduction. However, if a respondent were able to reduce his or her taxes by itemizing deductions, this procedure would overstate taxes and understate after-tax income.

Because the Federal tax law allows people to claim a tax credit for 20 percent of their child care expenses (up to a maximum credit of $400 per child for up to two children) estimates were made of the magnitude of those credits that each respondent could obtain. Those estimates were based upon the total number of children (one or more than one) claimed as dependents by the respondent as well as on 20 percent of the (annualized) amount of child care expenses that the respondent reported on the questionnaire.

The child care credit was used to offset all Federal income tax liabilities calculated (as previously described) from tax schedules X, Y, or Z. Net tax liabilities (insofar as they were positive) were then subtracted from taxable income to obtain preliminary estimates of after-tax income.

5. Adjustments to After-Tax Income

After-tax income was adjusted for social security taxes and for nontaxable income flows. Social security taxes were computed by taking 6.13 percent of the first $22,900 of taxable income. To the extent that taxable income was generated from exempt sources (such as dividends, interest, or other sources reported as income on the bankruptcy petition) or from governments or other employers exempt from social security, social security tax liabilities were overestimated. Nonetheless, because exempt sources could not be easily identified, all taxable income was deemed to be subject to social security taxes, and social security taxes, computed on that basis, were subtracted from income. The annual value of alimony payments was also subtracted from after-tax income. Finally, the annual value of any nontaxable income received by the respondent was added to after-tax income. In addition, for those people who received them, the annual value of food stamps was added to after-tax income.

The final after-tax income measure, then, included taxable income less Federal income taxes, less social security taxes, less alimony, plus nontaxable income, plus the annual value of food stamps. State income taxes, if applicable, were not computed since (1) it was extremely difficult to do so given wide variations in state laws and (2) there were many reasons to believe that Federal taxes were overestimated.

C. Example of After-Tax Income Calculations

The computation of after-tax income is illustrated for a hypothetical case in Exhibit 3-4, lines 1-10. Line one multiplies monthly income reported on the questionnaire by 12 to obtain annual income. In this case, since petition data and questionnaire data corresponded closely, no adjustment was required. Line two deducted Federal tax exemptions ($1,000/dependent) from taxable income to obtain line three. After determining from marital status data that the applicable tax schedule was schedule Y, and from specific data on medical expenses and property taxes that no extraordinary deductions were necessary, Federal tax liabilities were determined from schedule Y of the 1980 Federal Tncome Tax Tables. That schedule automatically grants the standard deduction to all taxpayers.

Because our hypothetical consumer had child care expenses, his or her taxes were reduced by the applicable child-care credit in line five, to determine the respondent's net Federal income tax liability, line six. Social security taxes were computed and added to total Federal tax liabilities in line seven. If applicable, alimony payments would be included with tax liabilities as an additional subtraction from income at this point. Federal tax liabilities (and, potentially, alimony) were then subtracted from pretax income to obtain after-tax income, line eight. Taxable income was then adjusted upward by adding in nontaxable income, such as workman's compensation or food stanps, in line nine, to obtain "adjusted family money income," line ten.

III. Calculation of Basic Living Expenses

A critical component in calculations of whether bankrupt debtors had sufficient income available to repay debts is the calculation of their basic living expense requirements. Their income must be sufficiently

EXHIBIT 3-4

SAMPLE CALCULATION OF AVAILABLE INCOME

FOR NONFARM FAMILY OF FOUR

A. Income Available to Apply to Nonmortgage Debts After Covering Basic Living Expenses

1. Family money income before taxes (monthly taxable income, 1,450 x 12)	$17,400	$17,400
2. Less: Exemptions (4 x 1,000)	4,000	
3. Taxable income (line 3, Schedule TC) (Line 1 - Line 2)	13,400	
4. Income tax (Tax Rate Schedule Y) [$1,404 + .21(13,400-11,900)]	1,719	
5. Less: Dependent care credit	400	
6. Net Federal income tax (Line 4 - Line 5)	1,319	
7. Social security tax (.0613 x 17,400)	1,067	2,386
8. Family money income after taxes (Line 1 - Line 6 - Line 7)		15,014
9. Add: Non-taxable income (workmen's compensation) (75 x 12)		900
10. Adjusted family money income (Line 8 + Line 9)		15,914
11. Basic living expenses (BLE) for low-income families adjusted for number of dependents and differences in cost of living by region and metropolitan/non-metropolitan places of residence	9,236	
12. Proportion of BLE assigned to non-housing expenditures (food, clothing, transportation, services, etc.) (.74 x 9,236)	6,835	
13. Actual housing costs (Rent, 260 + Utilities, 70) x (12)	3,960	

EXHIBIT 3-4--Continued

14. After-tax basic living expenses (BLE) (Line 12 + Line 13)	10,795	
15. Add: Extraordinary expenses (Child care, 170 per mo.) x (12)	2,040	
16. Adjusted after-tax BLE (Line 14 + Line 15)		12,835
17. Adjusted income available to apply to non-mortgage debts (Line 10 - Line 16)		3,079

B. Income Available to Apply to Non-Mortgage Debts After Covering Basic Living Expenses Plus 20 Percent of Non-Housing Expenses

18. Adjusted family money income (Line 10)		$15,914
19. BLE for non-housing expenses (Line 12)	6,835	
20. Add: 20% for higher living standard .20 x 6,835	1,367	
21. Add: Actual housing costs (Line 13)	3,960	
22. Add: Extraordinary expenses (Line 15)	2,040	
23. Adjusted BLE (Line 19 + Line 20 + Line 21 + Line 22)		14,202
24. Adjusted income available to apply to non-mortgage and non-business debts (Line 18 - Line 23)		$ 1,712

high that they can retain their residence, meet key necessary expenditures, and live at the poverty level or modestly above it in other ways while they are repaying their debts.

The calculation of basic living expenses involves several key steps. They are: (1) calculating minimum income requirements for families with the same number of dependents, (2) adjusting that income for intertemporal and interregional variations in prices, (3) calculating present housing costs, (4) substituting present housing expenses for housing expenses implicit in the minimum income calculations, and (5) allowing for necessary child-care expenses, excess child support payments, or excess medical payments which add to basic income needs. These steps are discussed in detail below.

A. Calculation of Price-Adjusted Minimum Income Requirements

Basic living expense requirements (BLE) were calculated by using the number of the debtor's reported dependents, determined from the questionnaire, in conjunction with estimates of poverty threshold standards for families of different sizes, calculated by the Bureau of the Census.[1] Initially, each respondent was assigned a BLE that was consistent with the poverty threshold for a family of equal size. For instance, the average poverty threshold for a nonfarm family of four was $8,414 in 1980.[2]

At the time the data were collected, the most recent data on poverty thresholds applied to 1979. Thus, an upward adjustment was made in all BLE estimates to reflect changes that occurred in the consumer price index before the study was conducted. The adjustment (an increase of 24 percent in all estimates) reflected the increase in the Consumer Price Index that occurred between mid-1979 and the commencement of the survey (April 1981). This adjustment was deemed appropriate because the Bureau of the Census makes annual revisions in its poverty thresholds by adjusting them upward by the year-to-year change in the Consumer Price Index. Hence, this adjustment was similar to those made by the Bureau of the Census, except it used a slightly longer time period. After adjustment, the poverty threshold for a family of four was $9,159.

However, because the data from the Bureau of Labor Statistics (BLS) indicate that substantial differences exist in the cost of living applicable to different parts of the country, additional adjustments were made to allow for such differences. Regional cost-of-living adjustments were based on BLS data for 1979, which provided detailed comparisons of the relative costs of living applicable to low-income families living in different parts of the country.[3]

Three basic adjustments were made. First the BLE for each respondent who lived in a city with a population under 50,000 was multiplied by the price index applicable to such cities in the region in which he lived. For instance, the BLE of an individual who lived in a small city in California (the west) was adjusted upward by eight percent. The BLE of a respondent who lived in Georgia (the south) was adjusted downward by 11 percent. In Illinois (the northcentral), the nonmetropolitan adjustment was a negative three percent, while in New York (the northeast) the adjustment was a minus one percent. This adjustment was the only one made if the respondent did not live in a standard metropolitan statistical area (SMSA) with a population of 50,000 or more.

The second price adjustment applied only to respondents who lived in major metropolitan statistical areas. The BLS calculates individual price indexes for 24 major cities, several of which were included in our survey. By using information on each respondent's zip code provided on the bankruptcy petition, we were able to determine if the respondent lived in an SMSA for which specific price indexes were available. If the respondent lived in such a city, that city's price index was used to adjust the BLE rather than the nonmetropolitan index described in the preceding paragraph. For instance, the BLE of a respondent who lived in Atlanta, Georgia, was decreased by only eight percent, rather than by the 11 percent applicable to the nonmetropolitan south. Further, the BLE of a respondent who lived in Chicago was increased by two percent rather than reduced by three percent. These adjustments reflected the fact tnat it cost more to live in specific big cities than in nonmetropolitan areas, while still allowing for regional differentials in the cost of living.

The third adjustment was similar to the adjustment cited in the preceding paragraph, except that it applied to residents of cities for which no specific price index was available. In this case, zip code information was used to determine if the respondent lived in a standard metropolitan statistical area (with a population of 50,000 or more) for which no specific price data were available. If so, the metropolitan price index applicable to metropolitan areas in that region of the country was used to adjust the BLE rather than the nonmetropolitan index. Thus, the BLE of a debtor who lived in Macon, Georgia, was adjusted downward by 5.1 percent rather than by the 11 percent adjustment applicable to southern residents of nonmetropolitan areas. Similarly, the BLE of a resident of Rockford, Illinois was increased by three percent rather than lowered by three percent, as would be the case if the respondent lived in a small town in the northcentral region of the country.

These three adjustments, then, had the effect of relating respondents' BLE levels to differences in the cost of living in different regions of the country, specific cities, and metropolitan vs. nonmetropolitan places of residence. Overall, then, a respondent's BLE was based on family size and adjusted both for intertemporal price changes and for interregional and metropolitan-nonmetropolitan differences in the cost of living for low-income families (Exhibit 3-4, line 11).

B. Calculation of Present Housing Costs

Respondents to the survey were asked to provide information on their monthly rent, mortgage, and utility expenses (if applicable). In addition, homeowners were asked to provide information on their annual property tax and insurance liabilities. Explicit housing costs for renters were calculated by multiplying rent and any utility payments by 12 and summing (Exhibit 3-4, line 13). Explicit housing costs for homeowners were calculated by multiplying monthly mortgage and utility payments by 12 and summing those figures with their annual property tax and insurance obligations. This information was collected on the questionnaire.

C. Calculation of Housing-Adjusted Basic Living Expenses

Because required minimum income levels include an allowance for housing expenses, simply adding present housing costs to initially determined BLE levels would provide for a double housing allowance.

Thus, housing-adjusted BLE levels were calculated by adding present housing and utility costs to a fraction of the previously determined BLE.

The fraction used was 74 percent (or 100 percent minus 26 percent). This statistic was based on the fact that the Consumer Expenditure Survey: Interview Survey, 1972-73, conducted by the BLS, showed that shelter and utility expenses for low-income families accounted for at least 26 percent of the expenditures of relatively low income families (see Exhibit 3-5).[4]

The housing-adjusted basic living expense concept, then, assumed that the debtor would make all the mortgage, rent, tax, insurance and utility payments necessary to continue to live in his or her current residence and would spend an amount equal to or greater than government minimum income standards on all other needs (such as food, clothing, and medical expenses). Because all mortgage, rent, insurance, tax and utility payments related to the debtor's current housing were explicitly taken into account (Exhibit 3-4, line 13), an adjustment was made to the initial basic living expense figure (Exhibit 3-4, line 12) to eliminate implicit shelter and utility expenditure allowances. This adjustment was necessary to prevent double counting the costs of shelter.

D. Alternative Levels of Basic Living Expenses

The assumption that all respondents would live in their present abodes and retain sufficient income after repaying debts to spend at or slightly above government minimum standards for a family of like size provides little leeway for discretionary expenditures. To make sure that individuals would definitely have more income than allowed by the

EXHIBIT 3-5

HOUSING EXPENDITURE AS A PERCENTAGE OF TOTAL CONSUMPTION EXPENDITURES (1972-73)

Income Class	Shelter, Utility, Property Tax and Property Insurance as a Percentage of Consumption
Under $3,000	34.21%
$3,000 - $3,999	30.73
$4,000 - $4,999	28.83
$5,000 - $5,999	28.16
$6,000 - $6,999	26.71
$7,000 - $7,999	25.28
$8,000 - $9,999	25.30
$10,000 - $11,999	24.25
$12,000 - $14,999	24.00
$15,000 - $19,999	23.79
$20,000 - $24,999	22.78
$25,000 or more	23.77

SOURCE: U.S. Department of Labor, Bureau of Labor Statistics, Consumer Expenditure Survey: Interview Survey, 1972-73, Volume 1, U.S. Tables, Families Classified by 10 Family Characteristics, Bulletin 1997, Washington, D.C., 1978, Table 1.

government's minimum income threshold, several alternative levels of living standards were calculated. These adjustments added 10 and 20 percent of the nonhousing BLE allowances to the previously calculated basic living expense level (see Exhibit 3-4, line 12 and part B). Thus, these alternative minimal income levels assumed that the debtor could live in the same housing unit, pay utility bills and make expenditures on other items at a rate that was, alternatively, 10 or 20 percent above the government's minimum expenditure standard for a family with the same number of dependents.

E. Extraordinary Expense Allowances

Some individuals may have extraordinary expenses that raise their minimal income needs. These include such things as child care expenses that must be incurred so parents can work, child support expenses mandated by law, or excessive medical expenses. Adjustments made to the various basic living expense levels to allow for these possibilities are described below.

1. Child care expenses

The questionnaire asked respondents to record monthly child care expenses that were necessary so that the parents could work. Provided that no parent were unemployed, this value was multiplied by 12 and added to each previous estimate of basic living expenses. (See Exhibit 3-4, lines 15 and 22. When applicable, extraordinary child support and medical expenses would also be added at this point.)

2. Child support expenses

Child support expenses are mandated by law. Thus, such expenses must be made before other expenditures. However, child support costs are made in lieu of direct expenditures on child support, Hence, it would be incorrect to add child support costs to basic living expense estimates because the basic living expense estimates already have been adjusted for the number of dependents in a family. Consequently, only that portion of child support costs that exceeded "usual" dependency allowances was added to BLE estimates. Further, such child support expenses were added only if they were deemed to be extraordinarily large.

"Usual" child support expenses were calculated from government data on poverty thresholds. In 1979, poverty thresholds were approximately $1,300 higher if a family had one additional dependent. Adjusted to April 1981 prices, the $1,300 (when increased by 24 percent for price increases) corresponded to an annual dependency allowance of $1,612 per child. Only those annual child support expenses that exceeded $1,612 times the number of dependents under 17 were considered to exceed child support expenses already allowed in the government statistics. Further, excess child support expenses were only allowed if they exceeded twice that threshold.

The requirement that child support expenses exceed twice the governmental dependent allowance was imposed because it was recognized that not everyone spent the same amount on child support. Some might spend more than that allowed by government threshold income definitions while others might spend less. The average level of expenditures, then, reflects the fact that some people spend more on children and less on other goods, while others do the reverse. Thus, some variation in spending on dependents was considered to be "normal." Adjustment in required living expenses was not considered necessary in "normal" cases. However, if child support requirements were twice as great as those allowed by poverty level definitions, they were considered to be extraordinarily large.

Consequently, whenever questionnaire data indicated that a respondent spent twice as much per dependent on child support as was implied by poverty level definitions, the difference between those expenditures and the implicit dependency allowance was added to the respondents' basic living expense requirement. This adjustment had the effect of adding extraordinarily large child support requirements to minimum income requirements whenever the child support requirements appeared to be excessive.

3. Medical expenses

An adjustment in basic living expenses was also made to allow for "excess" medical expenses. This adjustment was made analogously to the excess child support adjustment. From questionnaire data, annual medical expenses were calculated. Those expenses were divided by the number of dependents and were compared to the per capita medical expense allowance in the BLS 1979 low-income cost-of-living computation--after that allowance was adjusted to current dollar figures by changes in medical care costs from 1979 to 1981.[5] If annual medical expenses were "extraordinarily" large (i.e., were twice as great as the average medical allowance per capita), the difference between actual medical expenses and those allowed (on a current value per capita basis) by the low income cost-of-living computation was added to the respondent's basic living expense requirements.

F. Summary

Each respondent's basic living expenses were calculated by adding his or her explicit housing costs to nonhousing expenditures calculated to (1) equal the government's minimum income standard, (2) exceed that standard by ten percent, and (3) exceed that standard by 20 percent. In addition, necessary child care expenses and excessive child support and medical care expenses were added to each respondent's basic living expenses. All data necessary to make these calculations were obtained from the questionnaire.

IV. Income Available to Repay Debts

After-tax income that exceeded a respondent's basic living expenses was assumed to be available to repay debts. A different level of income available to repay debts was calculated for each alternative level of basic living expenses considered.

If after-tax income were understated, income available to repay debts would also be understated. Similarly, if minimal income needs were overstated, income available to repay debts would be understated. Conversely, any overstatements of after-tax income or any understatements of basic living expenses would cause estimates of income available to repay debts to be too high.

Because a conscious effort was made to estimate income conservatively, income available to repay debts was understated in many cases. Also, insofar as an individual's basic living expenses include an allowance for the purchase of automobiles or services provided by other durable goods, that individual's capacity to repay the principal on debts acquired to purchase durable goods would be understated. Part of the basic living allowance for auto or household expenses could be allocated to amortize debts used to acquire durable items.

V. Individuals' Abilities to Repay Nonmortgage Debts

A. Debtors' Ability to Repay Nonmortgage Debts from Income

Given individuals' income available to repay nonmortgage debts (the difference between their after-tax income and their basic living expenses) questions arise as to (a) what proportion of their debts consumers would repay in three, four, or five years, and (b) what percentage of consumers could repay their debts in full. Before these questions can be answered, the issue of what debts consumers can be expected to repay in a given period of time must first be resolved.

Mortgage payments are included in basic living expenses. Thus, the inclusion of home mortgages with debts to be repaid out of "income available to repay debts," would imply that homeowners should repay their mortgages twice. Further, because of mortgage debts' typically long-maturity, it does not make sense to consider such debts when making calculations of consumers' abilities to repay their debts in full in three, four, or five years. Also, insofar as mortgage debts applied to properties other than the home, the liquidation of those properties (such as second homes, etc.) generally should provide adequate funds to repay those debts--since mortgage lenders typically will not make a mortgage loan unless the value of the secured assets substantially exceeds the value of the mortgage. Similar reasoning applies to business debts, which typically are secured by the assets of the business. Thus, in all subsequent calculations, we focused only on consumer debts. This was done by subtracting all mortgage debts and business debts from the consumer's total debts.[6]

The following exhibits provide estimates of the percentages of consumer debts that bankrupt debtors could repay out of their "income available to repay debts" in three, four, or five years. The top line of each table shows the percentage that could repay their debts in full. The second line shows the percentage that could repay 75-100 percent of their debts. The third line shows the percentage that could repay 50-75 percent of their debts, etc. Finally, the last line of the exhibit shows the percentage that could not repay their debts at all.

Exhibits 3-6, 3-7, 3-8 show the percentage of respondent's who either could repay their nonmortgage, nonbusiness debts in full or repay various portions of their debts out of income left over after they met their basic living expenses. The exhibits also present data on average income and debt holdings. Exhibits 3-6, 3-7, and 3-8 assume three-, four-, and five-year repayment periods, respectively.

Exhibits 3-9, 3-10, and 3-11 are exactly analogous to Exhibits 3-6 to 3-8, except they inflate each respondent's basic living expenses with a 20 percent "cushion" for nonhousing expenditures. Calculations for the case where a ten percent cushion was assumed are not shown. Those results are highly similar to the other results, as repayment capacities are not highly sensitive to the "cushion" assumptions over the range of zero to 20 percent.

EXHIBIT 3-6

ABILITY TO REPAY NONMORTGAGE DEBT FROM INCOME IN THREE YEARS AFTER MEETING BASIC LIVING EXPENSES

Could Repay	Number of Petitioners	Percent of Respondents	Cumulative Percentage	Average Non-mortgage, Non-business Debt	Average Debt Repayable in Three Years	Average Taxable Income	Average Income (After Taxes and Alimony, Plus Nontaxable Income)
100% or more	217	20.3%	20.3%	$10,527	All	$17,944	$15,862
75-99.9%	61	5.7	26.0	13,719	$11,775	14,212	13,122
50-74.9%	57	5.3	31.3	19,044	11,638	16,072	13,775
25-49.9%	80	7.5	38.8	26,952	10,319	14,219	13,114
0.1-24.9%	97	9.1	47.9	35,545	5,387	12,064	11,221
0% or less	558	52.1	100.0	18,776	None	5,650	6,366

SOURCE: Credit Research Center, Purdue University, Consumer Bankruptcy Study.

EXHIBIT 3-7

ABILITY TO REPAY NONMORTGAGE DEBTS FROM INCOME IN FOUR YEARS AFTER MEETING BASIC LIVING EXPENSES

Could Repay	Number of Petitioners	Percent of Respondents	Cumulative Percentage	Average Non-mortgage, Non-business Debt	Average Debt Repayable in Four Years	Average Taxable Income	Average Income (After Taxes and Alimony, Plus Nontaxable Income)
100% or more	278	26.0%	26.0%	$11,227	All	$17,125	$15,261
75-99.9%	38	3.6	29.5	17,085	$15,282	15,350	13,475
50-74.9%	63	5.9	35.4	26,309	16,186	16,545	14,601
25-49.9%	57	5.3	40.7	37,588	13,054	13,339	11,861
0.1-24.9%	76	7.1	47.9	29,478	4,440	11,025	10,720
0% or less	558	52.1	100.0	18.776	None	5,650	6,366

SOURCE: Credit Research Center, Purdue University, Consumer Bankruptcy Study.

EXHIBIT 3-8

ABILITY TO REPAY NONMORTGAGE DEBTS FROM INCOME IN FIVE YEARS AFTER MEETING BASIC LIVING EXPENSES

Could Repay	Number of Petitioners	Percent of Respondents	Cumulative Percentage	Average Non-mortgage, Non-business Debt	Average Debt Repayable in Five Years	Average Taxable Income	Average Income (After Taxes and Alimony, Plus Nontaxable Income)
100% or more	310	29.0%	29.0%	$11,945	All	$17,058	$15,156
75-99.9%	44	4.1	33.1	19,420	$16,444	15,335	13,544
50-74.9%	46	4.3	37.4	30,061	19,558	14,687	13,556
25-49.9%	53	5.0	42.3	41,417	15,285	13,374	11,884
0.1-24.9%	59	5.5	47.9	28,397	4,384	10,802	10,467
0% or nothing	558	52.1	100.0	18,776	None	5,650	6,366

SOURCE: Credit Research Center, Purdue University, Consumer Bankruptcy Study.

EXHIBIT 3-9

ABILITY TO REPAY NONMORTGAGE DEBTS FROM INCOME IN THREE YEARS AFTER MEETING BASIC LIVING EXPENSES PLUS A 20 PERCENT CUSHION

Could Repay	Number of Petitioners	Percent of Respondents	Cumulative Percentage	Average Non-mortgage, Non-business Debt	Average Debt Repayable in Three Years	Average Taxable Income	Average Income (After Taxes and Alimony, Plus Nontaxable Income)
100% or more	159	14.9%	14.9%	$10,601	All	$19,037	$16,612
75-99.9%	51	4.8	19.6	12,884	$11,313	15,921	14,462
50-74.9%	55	5.1	24.8	16,820	10,713	15,262	13,165
25-49.9%	77	7.2	32.0	27,965	10,319	16,546	14,846
0.1-24.9%	87	8.1	40.1	32,748	5,752	13,411	12,144
0% or less	641	59.9	100.0	18,748	None	6,268	6,888

SOURCE: Credit Research Center, Purdue University, Consumer Bankruptcy Study.

EXHIBIT 3-10

ABILITY TO REPAY NONMORTGAGE DEBTS FROM INCOME IN FOUR YEARS AFTER MEETING BASIC LIVING EXPENSES PLUS A 20 PERCENT CUSHION

Could Repay	Number of Petitioners	Percent of Respondents	Cumulative Percentage	Average Non-mortgage, Non-business Debt	Average Debt Repayable in Four Years	Average Taxable Income	Average Income (After Taxes and Alimony, Plus Nontaxable Income)
100% or more	210	19.6%	19.6%	$11,155	All	$18,280	$16,089
75-99.9%	42	3.9	23.6	17,947	$15,858	16,225	13,965
50-74.9%	47	4.4	27.9	25,000	15,037	16,044	13,856
25-49.9%	73	6.8	34.8	32,913	11,456	15,800	14,267
0.1-24.9%	57	5.3	40.1	28,001	5,319	12,127	11,306
0% or less	641	59.9	100.0	18,748	None	6,268	6,888

SOURCE: Credit Research Center, Purdue University, Consumer Bankruptcy Study.

EXHIBIT 3-11

ABILITY TO REPAY NONMORTGAGE DEBTS FROM INCOME IN
FIVE YEARS AFTER MEETING BASIC LIVING EXPENSES
PLUS A 20 PERCENT CUSHION

Could Repay	Number of Petitioners	Percent of Respondents	Cumulative Percentage	Average Non-mortgage, Non-business Debt	Average Debt Repayable in Five Years	Average Taxable Income	Average Income (After Taxes and Alimony, Plus Nontaxable Income)
100% or more	242	22.6%	22.6%	$12,153	All	$17,995	$15,805
75-99.9%	38	3.6	26.2	17,306	$14,830	15,845	13,634
50-74.9%	46	4.3	30.5	28,824	18,254	15,718	14,638
25-49.9%	57	5.3	35.8	40,065	14,499	15,741	13,640
0.1-24.9%	46	4.3	40.1	23,085	4,960	11,781	11,059
0% or less	641	59.9	100.0	18,748	None	6,268	6,888

SOURCE: Credit Research Center, Purdue University, Consumer Bankruptcy Study.

B. Minority Debtors' Ability to Repay Nonmortgage Debts From Income

One question that has been raised is whether minority group members would be deemed less or more able to repay debts once their income and basic living expenses had been covered. Consequently, we made a separate analysis of minority debtors' potential ability to repay debts. Exhibit 3-12 presents results of that analysis for Black and Hispanic respondents. That exhibit is comparable to Exhibit 3-8 for the sample as a whole. Exhibit 3-8 was selected for comparison purposes because the maximum percentage of debtors can repay their debts if they repay them over five years and are assumed to spend their income only for their basic living expenses and nonmortgage debt repayment.

Visual comparisons of Exhibits 3-8 and 3-12 suggest that minority group members are almost identical to the bankruptcy sample as a whole in terms of their ability to repay their debts. We found almost identical percentages were able to repay (1) no debts (50.5 percent for minorities and 52.1 percent for the full sample), (2) at least half their debts (38.3 percent for minorities and 37.4 percent for the full sample). and (3) all their nonmortgage debts (30.6 percent for minorities and 29.0 percent for the full sample). Furthermore, average debt and income levels for both those able to repay in full and not able to repay at all were very similar. Thus, it appears that minority group members have exactly equal capacities to repay debts under our assumptions as bankrupt debtors in general.

EXHIBIT 3-12

ABILITY TO REPAY NONMORTGAGE DEBTS FROM INCOME IN FIVE YEARS AFTER MEETING BASIC LIVING EXPENSES

(BLACKS AND HISPANICS ONLY)

Could Repay	Number of Petitioners	Percent of Respondents	Cumulative Percentage	Average Non-mortgage, Non-business Debt	Average Debt Repayable in Five Years	Average Taxable Income	Average Income (After Taxes and Alimony, Plus Nontaxable Income)
100% or more	60	30.6%	30.6%	$10,888	All	$19,696	$15,664
75-99.9%	9	4.6	35.2	11,042	$ 9,740	10,747	10,748
50-74.9%	6	3.1	38.3	22,480	13,318	13,907	11,533
25-49.9%	7	3.6	41.8	14,501	5,919	9,319	9,376
0.1-24.9%	15	7.7	49.5	39,057	3,237	11,351	10.618
0% or less	99	50.5	100.0	11,609	None	6,173	6,390

SOURCE: Credit Research Center, Purdue University, Consumer Bankruptcy Study.

C. Debt Repayments as a Percentage of Income

To ensure that our assumptions regarding debt repayment capacity did not impose an inordinate burden on low income people, we calculated the average proportion of income that we assumed would be devoted to debt repayment by various income classes. The results of those calculations are presented in Exhibit 3-13. They indicate that on average, most people (some people with low housing expenses and few dependents might be an exception) with money incomes below $10,000 could not devote any income to repaying debts. In the $10,000-$15,000 income bracket a relatively small proportion of income (2.5 percent to 11.7 percent on average) could be devoted to repaying debts. At income levels of $20,000 or above, the proportion of income devoted to debt repayment increased until it reached 37 percent to 39 percent for respondents with annual incomes over $35,000. Thus, the data in Exhibit 3-13 suggest that assumed debt repayment payment burdens will not fall disproportionally, if at all, on low income consumers. Rather, they will fall most heavily on the relatively well-to-do.

D. Comparative Levels of Basic Living Expenses

Underlying our assumption that many consumer debts can be repaid out of income is the assumption that consumers will have some money left over after meeting their basic living expenses. Since basic living expenses vary substantially with the number of dependents it is instructive to analyze them, and compare them to living expenses for a family of four to Bureau of Labor Statistics living expenses calculations for a family of four that lives on a typical "lower-income" budget. It also is useful to compare our calculations of basic living expenses to poverty thresholds calculated by the Census Bureau. Relevant data are presented in Exhibit 3-14.

EXHIBIT 3-13

FREQUENCY DISTRIBUTION SHOWING AVERAGE ABILITY TO REPAY RATIOS BY INCOME

Annual Income Level (last month's earnings times 12 or last years total income)	Number of Respondents	Average ratio of income in excess of "Basic Living Expenses" to annual income*	Average ratio of income in excess of "Basic Living Expenses plus 20% Cushion" to annual income**
Under $3,000	43	-6.736	-7.774
$3,000 - $4,999	69	-0.792	-1.047
$5,000 - $7,499	150	-0.302	-0.469
$7,500 - $9,999	161	-0.096	-0.218
$10,000 - $14,999	241	0.117	0.025
$15,000 - $19,999	115	0.208	0.138
$20,000 - $24,999	71	0.304	0.250
$25,000 - $34,999	33	0.338	0.294
$35,000 plus	17	0.394	0.370

*These ratios equal the average of annual Disposable Income (DI) less annual Basic Living Expenses (BLE) divided by annual income (y), calculated as $\left(\sum_{i=1}^{n} (DI_i - BLE)/y_i \right)/n$ where n equals the number of respondents in each group. Large negative values occur in low income groups because estimates of basic living expenses are very high relative to actual income levels. If key data were lacking or earned income was zero, no calculations were made. Positive values such as the 0.117 for the $10,000 - $14,999 income bracket should be read as indicating that, on average, income in excess of basic living expenses averaged 11.7% of total income for members of that group.

**These calculations are identical to those in the middle column, except that Basic Living Expenses plus a 20 percent confort allowance was subtracted from disposable income instead of just BLE.

SOURCE: Credit Research Center, Purdue University, Consumer Bankruptcy Study.

EXHIBIT 3-14

AVERAGE LIVING EXPENSES FOR FAMILIES OF DIFFERENT SIZES

Dependents	Total Number/ Number on Which Calculations Are Based	Basic Living Expenses (April 1981) BLE	BLE + 20	BLS "Low Income Budget" (Autumn 1980)	Bureau of Census Price Adjusted Poverty Level (April 1981)
1	257/229	$ 7,907	$ 8,562		$ 4,567
2	214/187	9,698	10,518		5,830
3	246/216	10,820	11,828		7,146
4	256/235	13,657	14,959	$14,044	9,159
5	122/112	14,288	15,825		10,833
6	62/56	14,802	16,528		12,213
Over 6	42/37	16,351	17,431		15,143

SOURCE: Credit Research Center, Purdue University, Consumer Bankruptcy Study.

NOTE: Insufficient data on one or more critical items (such as income, dependents, etc.) were available to calculate basic living expenses for all respondents. Hence, the number of respondents on which calculations were based was approximately ten percent less than the number of respondents who fell in each category.

The data presented in Exhibit 3-14 show that basic living expenses calculated for use in this study rise substantially with family size--both because of rising dependent allowances and because of increases in actual housing costs. For a family of four, our calculated basic living expenses plus taxes averaged $13,657, and basic living expenses plus a 20 percent nonhousing expense "cushion" and taxes averaged $14,959. These figures bracketed the BLS statistics showing that a typical lower-income family budget called for an income of $14,044 in Autumn 1980. Adjusting for inflation to April 1981 would imply that the BLS lower-income budget would be approximately $14,900 for the same point in time as our basic living expense calculations. However, that budget also allowed for some saving and debt repayment so that, on balance, it measured more than is included in our basic living expense calculations. Consequently, we conclude that our basic living expense calculations are both very similar to the BLS's lower income budget. Probably it approximates most closely the cases where a ten percent or 20 percent "comfort" allowance is allowed--which is consistent with the fact that the BLS standard is assumed to be a typical budget, not a basic living expense budget, for a lower-income family.

The data presented in Exhibit 3-14 also show that our basic living expense allowances substantially exceed government poverty threshold calculations. The differences are particularly marked (averaging close to $4,000 per family) for families with less than six dependents. These differences arose because our calculations assumed that existing housing expenses would be continued.

VI. Ability to Repay Debts out of Assets

Business debtors frequently are lent money based on their pledge of assets as collateral to guarantee repayment--and are considered insolvent when their liabilities exceed their assets. However, consumer debtors typically do not borrow against assets, but rather, borrow against future income. Nonetheless, the question has arisen as to whether consumer debtors have the ability to repay debts out of assets.

Exhibit 3A-1 in the Appendix indicates that average secured debt holdings on bankruptcy petitions is less than the market value of property used to secure the debt. Thus, it is conceivable that some consumer bankruptcy petitioners could repay their debts by liquidating assets rather than by repaying debts from future income. However, large exemptions in the bankruptcy laws may reduce their need to do so.

Exhibit 3-15 and 3-16 provide some insight into consumers' ability to repay debts from assets, rather than income. Exhibit 3-15 indicates that, after allowing for assets exempt from seizure to repay debts, only 5.3 percent of the bankruptcy petitioners could repay their debts by liquidating their assets. However, Exhibit 3-16 indicates that it would not be wise for most to repay their debts by liquidating assets. Approximately half of the people who could repay their debts from assets could repay none of their debts from income. Thus, if they liquidated their assets, they would have nothing on which to live. Furthermore, only 20 to 28 percent of them would be able to repay their debts in full if they chose to repay debts out of income rather than out of assets.

EXHIBIT 3-15

PERCENTAGE OF DEBTORS MEETING SOLVENCY TEST[a]

(PERCENTAGE OF DEBTORS)

	Number	Percent
Solvent debtors	63	5.3
Insolvent debtors	1,127	94.7
Totals	1,190	100.0

[a] Debtors are categorized as solvent if reported assets, less exemptions, exceeded reported debts. In several cases petition data were not available or usable.

SOURCE: Credit Research Center, Purdue University, Consumer Bankruptcy Study.

EXHIBIT 3-16

PERCENTAGES OF NONMORTGAGE DEBTS[a] THAT COULD BE REPAID IN 36 MONTHS FROM AVAILABLE INCOME BY DEBTORS CATEGORIZED AS SOLVENT[b]

(PERCENTAGE OF DEBTORS)

Percentage of Non-Mortgage Debt Repaid	Basic Living Expense			Basic Living Expense Plus 20 Percent of Non-Housing Needs		
	N	Percent	Cumulative Percentage	N	Percent	Cumulative Percentage
100% or more	18	28.6	28.6	13	20.6	20.6
75% to 99.9%	7	11.1	39.7	2	3.2	23.8
50% to 74.9%	2	3.2	42.9	3	4.8	23.6
25% to 49.9%	4	6.3	49.2	7	11.1	39.7
0% to 24.9%	2	3.2	52.4	5	7.9	47.6
None	30	47.6	100.0	33	52.4	100.0
Totals	63	100.0		63	100.0	

[a] Non-mortgage debt excludes mortgage and business debts.

[b] Debtors are categorized as solvent if reported assets, minus exemptions, exceeded reported debts.

SOURCE: Credit Research Center, Purdue University, Consumer Bankruptcy Study.

VII. Summary and Conclusions

Analysis of data from 1,199 bankruptcy petitions and personal interviews indicates that, depending upon the assumptions made, 15 percent to 30 percent of bankrupt debtors probably could repay all of their nonmortgage debts out of their future income, while as many as 37.4 percent of bankrupt debtors probably could repay at least half their debts out of future income. This finding makes sense because a large proportion of the bankruptcy petitioners were employed full-time and most had had at least one wage-earner employed full-time for the previous year. The percentage of people who could repay their debts varied little by racial affiliation.

Because consumers typically borrow aginst future income rather than assets, only five percent of the respondents could repay their debts by liquidating assets, and half of those would not have been able to repay their debts from future income. Thus, overall, it appears that a future income test provides a more equitable test than an assets test in determining which consumers potentially could repay their debts.

FOOTNOTES

[1] U.S. Department of Commerce, Bureau of the Census, *Current Population Reports, Series P-60, No. 125: Money Income and Poverty Status of Families and Persons in the U.S. 1979*. Washington, D.C., September 11, 1980.

The data used in this study were applicable to the entire U.S. population. This resulted in a substantial overstatement of farm family poverty levels (by 14 percent for a family of four) and a minimal understatement of urban poverty levels (by 0.35 percent for a family of four). Ideally separate poverty levels would be used for farm and nonfarm families, but it was not easy to determine from the questionnaire and petition data which respondents were farmers.

[2] U.S. Department of Commerce, Bureau of the Census, *Current Population Reports Series P-60, No 125, Money, Income and Poverty Status of Families and Persons in the United States, 1980*. Washington, D.C. August, 1980, pp. 39.

[3] U.S. Department of Labor, Bureau of Labor Statistics, *Autumn 1979 Urban Family Budgets and Comparative Indexes for Selected Urban Areas*, Washington, D.C. April 30, 1980, Table 4.

[4] Our objective in calculating housing-adjusted basic living expenses was to ensure that an individual could continue to live in his/her present residence and have enough income to spend an amount equal to or greater than poverty thresholds on other things. While it was relatively easy to determine the poverty thresholds from government data, those data did not indicate what share of those expenditures were assumed to be allocated to different purposes. Only food expenditures (which were initially defined to be one-third of such spending) were known with certainty. Thus, it was necessary to estimate the implicit housing allowance embodied in the government definition. The best source for doing so was deemed to be the 1972-1973 *Consumer Expenditure Survey* data compiled by the Bureau of Labor Statistics. Those data provide detailed information on spending by families of different income levels for use in preparing the Consumer Price Index (CPI).

Exhibit 3-5 shows the proportion of total consumption expenditures allocated to shelter, utilities, property taxes, and insurance by households in each income group. As can be seen, the proportion of housing related expenses varies inversely with the income level. The poorest people devote a large portion of their total consumption outlays to housing expenditures.

FOOTNOTES (continued)

Because housing expenditures are high for low income poverty level people and the fact that an Indiana welfare agency assumes poor people spend 35 percent of their income on housing, we initially considered using a 35 percent housing adjustment in our calculations. However, the BLS data indicated that people at somewhat higher income levels spend a lower percentage of their income on housing. Consequently, we adopted a 26 percent housing allowance assumption. If anything, that assumption should understate total housing expenses made by families with incomes below $7,500 in 1972-73 dollars. Thus, it should provide a generally low estimate of housing needs for all low income families in 1981. To the extent that the 26 percent assumption actually understates the amount of housing expenses embodied in poverty threshold allowances, it will overstate non-housing expense allowances. Consequently, we used the 26 percent adjustment to ensure that, if anything, the non-housing expense allowances embodied in our "Basic Living Expense" calculations would equal or exceed poverty thresholds.

[5] U.S. Department of Labor "Autumn 1979, Urban Family Budgets," op.cit., Table A.

[6] There was little difference in results obtained when this approach was used and when an alternative approach, which subtracted only first mortgage debts from total debts, was used. Overall, the second approach found that approximately one percent fewer consumers could repay all their debts (except first mortgages) in three to five years than could repay all their debts except mortgage and business debts. The discrepancy was small because most debtors did not have business debts or mortgage debts not secured by their home.

Evidence also exists that many debtors could liquidate their business and investment debts out of assets--even though the alternate calculations did not consider that possibility. While business inventories averaged slightly less than business debts, both second houses and investment assets were worth considerably more than related debts (see the Appendix).

CHAPTER 3 APPENDIX

COMPARISON OF RESPONDENTS AND NONRESPONDENTS

An important issue to investigate is whether the 1,199 bankrupt debtors who were approached and consented to an interview were representative of bankrupt debtors in general. If the 1,050 petitioners who declined an interview differed systematically from those who accepted, the generality of the survey's results could be questioned.

Thus, the survey design called for obtaining as much information as possible on debtors who declined interviews as well as on people who accepted. This objective was accomplished by coding as much data as possible from the bankruptcy petitions of both those people who responded affirmatively to a request for an interview and those people who declined. Exhibit 3A-1 summarizes key responses for each of the two groups.

Basically, the data presented in Exhibit 3A-1 suggest that there were great similarities among respondents and nonrespondents to the survey. Their 1980 average incomes (which was the primary determinant of their ability to repay debts) were practically identical. In addition, both groups were very likely to use lawyers, each group had slightly over 10 percent who had previously declared bankruptcy, and the incidence of unusual transfers and surrenders of property prior to bankruptcy was very similar for both groups. The two groups differed, however, in the extent of their average indebtedness.

Based on average data, it appeared that the nonrespondents held more debt, and also more assets, than the respondents. However, the averages are somewhat misleading because the nonrespondent sample contained more people with very large debts. In particular, 2.2 percent of the nonrespondents had over $300,000 worth of debts while only 0.6 percent of the respondents had that much debt. Because every $1 million in debts adds $1,000 to the average debt statistics, a relatively small number of large debts can inflate the average debt statistics substantially.

Consequently, when the distribution of debt statistics is examined in more detail it appears that average debts for the two samples are more similar than might otherwise be apparent. In particular, looking only at people with debts under $50,000, the average debt holdings of both respondents and nonrespondents were in the $15,000 range. The nonrespondents differed mainly in that 77 percent of their number fell in this category, while 84.9 percent of the respondents held less than $50,000 in debt.

Average debt holdings of respondents in each debt category usually were also very similar. However, the percentage of consumers holding large amounts of debt was generally higher for nonrespondents than for respondents. For instance, 10.6 percent of the nonrespondents had debts over $100,000 while only 5.5 percent of the respondents had debts that large. There was also a slightly higher percentage of business-related filings (7.7 percent to 6.0 percent) among the nonrespondents, and slightly more (29.3 percent vs. 27.5 percent) were homeowners. These two factors could have accounted for much of the discrepancy in large debtors that existed in the two samples.

Additional analysis of debtors with over $500,000 in debts indicated that several had lost lawsuits while others had suffered from unincorporated business losses. Probably their prior legal difficulties had made such petitioners unwilling to spend any additional time in court. As a result, nonrespondents in this group outnumbered respondents by eight to two.

Overall, then, most characteristics of debtors in the two samples were highly similar. On average, the nonrespondents held more debts, but this mainly reflected the fact that large debtors were less likely to respond. Since incomes were nearly identical and the vast majority of people held similar amounts of debt, the differences in the nonrespondents were expected to have little effect on calculations of the percentage of people who could repay their nonmortgage, nonbusiness debts.

EXHIBIT 3A-1

COMPARISON OF BANKRUPTCY PETITION DATA FOR SURVEY RESPONDENTS AND NONRESPONDENTS

	Respondents (1199)	Nonrespondents (1050)
Average taxable income:		
Wages	13,101.07 (1084)	13,172.27 (905)
Other	758.00 (1041)	697.05 (889)
Total	13,979.29 (1014)	13,924.47 (860)
Average assets:		
Total	15,767.39 (1182)	19,670.66 (1019)
Real	10,309.91 (1185)	14,504.44 (1019)
Average exemptions	7,035.91 (1168)	7,884.77 (981)
Average debt:		
Secured debt A2 (p46)	15,260.44 (1189)	20,033.75 (1026)
Unsecured debt A3	14,657.06 (1191)	23,316.79 (1028)
Total	30,245.59 (1191)	43,608.59 (1028)
Total debt distribution:		
Under 50,000	15,274 (1010-84.9%)	15,824 (809-77.0%)
50,000-100,000	67,358 (117-9.6%)	68,405 (130-12.4%)
100,000-200,000	130,261 (35-2.9%)	131,950 (52-5.0%)
200,000-300,000	240,172 (14-1.2%)	235,314 (14-1.3%)
300,000-400,000	365,893 (1-0.1%)	342,143 (9-0.9%)
400,000-500,000	418,904 (4-0.3%)	444,562 (6-0.6%)
500,000 +	1,314,686 (2-0.2%)	904,046 (8-0.8%)
Debt except mortgages and business	19,050.71 (1191)	30,906.02 (1028)
Debt except first mortgages	22,215.59 (1191)	34,059.59 (1028) 1 missing
Homeownership:		
1st mortgage amount	25,794.38 (332)	28,752.13 (307)
Value of house	36,776.51 (288)	40,152.76 (271)
2nd mortgage amount	16,330.97 (92)	19,354.35 (107)
Value of house	52,360.92 (77)	52,192.32 (89)
Second house amount	29,403.10 (10)	27,261.93 (14)

EXHIBIT 3A-1--_Continued_

	Respondents (1199)	Nonrespondents (1050)
Secured debt amount (p55)	15,280.68 (1188)	19,910.38 (1026)
Market value of secured items	15,594.52 (1040)	19,920.00 (911)
Business debt (inventories)	22,466 (26)	13,463 (24)
Business inventory values	18,154 (19)	10,258 (18)
Investment property debts	22,760 (30)	24,923 (35)
Investment property values	33,575 (25)	42,916 (26)
	Other Data	
Legal services used	95.8% (1177)	97.7% (1027)
Legal fees	$381.37 (1007)	$424.00 (902)
Business form used	6% (1199)	7.7% (1029)
Prior bankruptcy (bus. form)	7.1% (56)	10.4% (77)
Prior bankruptcy (standard)	10.8% (1094)	11.2% (916)
Overall, prior bankruptcy (%)	10.2% (1199)	10.8% (1029)
Property garnished	32.9% (1108)	32.4% (931)
Unusual gifts	1.5% (1112)	1.6% (930)
Other transfers	9.2% (1103)	11.9% (933)
Voluntarily surrendered property	19.3% (1115)	20.4% (933)

EXHIBIT 3A-1--Continued

Distribution of Debt Except Mortgage and Business Debt
(Based on Total Debt)

Total Debt ($)	Nonmortgage Nonbusiness Debt ($)	All Debt Except First Mortgages ($)
Under 50,000	9,503	10,917
50 - 100,000	33,208	38,235
100-200,000	84,421	92,775
200-300,000	160,293	154,824
300-400,000	272,083	291,339
400-500,000	261,550	406,448
500,000 +	1,299,236	739,827

SOURCE: Credit Research Center, Purdue University, Consumer Bankruptcy Study.

TESTIMONY OF
THE AMERICAN BANKERS ASSOCIATION

Mr. Chairman, I am Bill W. Dixon, First Vice President of First Wisconsin Milwaukee. I am testifying today on behalf of the American Bankers Association. The American Bankers Association consists of more than 90 percent of the nation's full service banks including large money center banks, regional banks, and more than 12,000 community banks with deposits of $100 million or less.

We greatly appreciate this opportunity to appear before this Subcommittee to discuss our position on the important bankruptcy issues facing this Congress.

Bankruptcy Court Reform

I. Need for Certainty

The members of the American Bankers Association want to stress the urgent need for a resolution of the current problems and confusion in the bankruptcy courts occasioned by the U.S. Supreme Court decision in Northern Pipeline Construction Co. v. Marathon Pipe Line Co., 102 S.Ct.2858 (1982)).

In that case, four justices, (Brennan, Marshall, Blackmun and Stevens) held that the broad jurisdictional grant of the Bankruptcy Reform Act of 1978 could only be exercised by judges having the protections afforded by Article III of the United states Constitution (i.e., lifetime tenure subject to removal only by impeachment and irreducible compensation). Because the present bankruptcy judges do not have lifetime appointments and are subject to having their salaries reduced by Congress, the four justices concluded that all of the bankruptcy court's jurisdiction is unconstitutional.

Two other justices (Rehnquist and O'Connor) joined the four justices to form the majority in the Court's six-to-three decision, but based their decision on narrower grounds. The two justices made it clear that they were not ruling on whether or not all the jurisdictional grant of the Bankruptcy Reform Act of 1978 is unconstitutional. Instead, their opinion was specifically limited to a consideration of the bankruptcy court's jurisdiction over the type of case involved in the Northern Pipeline situation (i.e., breach of contract action arising under state law brought by a Chapter 11 debtor in possession against a third party). They concluded that only an Article III judge could exercise this type of jurisdiction.

Three justices dissented (White, Burger and Powell) arguing that the entire jurisdictional grant under the Bankruptcy Reform act of 1978 was proper and could be exercised by judges of less than Article III stature.

The Court stayed their decision until October 4, 1982 and later until December 24, 1982. Despite the efforts of many Senators and Representatives, Congress was unable to resolve the many issues involved in restucturing the courts. As a result, on December 25, 1982, the courts began operating with an Interim Rule suggested by the Judicial Conference.

Problems under the rule fall in two categories. First, there are problems relating to the interpretation of the Interim Rule itself and how it should be administered. Second, there is the more serious question as to whether the rule itself is valid.

a. Administration of the Rule

Two examples of specific problem areas in the interpretation or administration of the rule may serve to illustrate our concerns. First, in most Chapter 11 reorganizations, a debtor must obtain immediate approval from the court for a financing arrangement for the debtor-in-possession or the trustee in order to keep the company operating.

Obtaining this credit is governed by section 364 of the Code and is generally contigent upon the creditor getting a section 503(b)(1) administrative priority for that creditor or collateral to secure the extension of credit. Under the current rule, there is some confusion as to whether this priority or collateral can be given by the bankruptcy court or whether the district court must issue the order. We have already become aware of debtors who have lost substantial time in finding a district judge who would countersign the order of a bankruptcy judge.

Also, in this case as in most proceedings, there is some question as to what degree of review the district judge must undertake. There is some concern that a simple countersigning of orders by a district judge does not constitute sufficient participation by an Article III judge to validate the order. It may be necessary for the district judge to review the hearing transcript or to hold a de novo hearing in order to validate matters initially reviewed by the bankruptcy judge.

Second, similar problems arise in the sale of excess assets such as the situation where a farmer desires to sell appreciated land free and clear of state law liens in order to finance the planting of a crop. Today many title insurance companies are reluctant to insure such transfers. Again, it is unclear whether a bankruptcy court order is sufficient.

In summary, there are and will be a number of questions under the rule as to what matters can be handled by the bankruptcy court and what matters must be handled by an Article III court.

b. Validity of the Rule

Of greater concern in the administration of bankruptcy proceedings is the lack of certainty as to the validity of the rule itself. Several commentators have suggested, based on the sweeping language in the Brennan Opinion, that the "broad grant" of bankruptcy court jurisdiction is unconstitutional, that there can be no bankruptcy court system.

The question of whether bankruptcy jurisdiction is inherited in bulk by the district courts, is based on the effect given to the initial grant of bankruptcy jurisdiction to the district courts as contained in 286 U.S.C. Sec.1471(a) and a similar jurisdictional grant contained in 28 U.S.C. Sec.1334 as it remains in effect until April 1, 1984.

Other commentators have argued that the Marathon decision prohibits federal courts (both district and bankruptcy) from exercising jurisdiction in adversary proceedings involving state or common law claims, but argue that federal district courts can continue to exercise all other jurisdictions created by the Code.

Whether these commentators are right or wrong has been argued vehemently in recent weeks. Reasonable minds differ on the answers to the complex questions they raise. Only the Supreme Court can ultimately answer the questions. However, in the meantime, the doubt and uncertainty created by the question of validity of the rule can cause irreparable harm.

Virtually every adversary proceeding under the

Bankruptcy Code is tainted with this question. As a result, all parties are reluctant to rely on court orders, companies are hesitant about using the protections of Chapter 11 when faced with financial difficulties, and settlements and compromises are harder to reach.

In seeking to reorganize an ailing company, all parties are hoping to receive something more than they would under a liquidation. But if doubts arise as to whether the parties will get more than they would in a liquidation or what they bargained for in the reorganization process, then they will be reluctant to bargain at all. As a result, we would see more Chapter 7 liquidations rather than Chapter 11 reorganizations.

Confusion in the courts could also lead to some withdrawal of creditors from the market. Small, medium, and even larger companies that are experiencing financial problems will soon find lenders to be more stringent in passing on credit requests or that costs are higher to compensate for higher risks.

In summary, the need for quick action by this Congress to resolve the uncertainty is clear. We urge this Subcommittee to move this legislation forward with all deliberate speed.

II. Structure of Courts

Having stated the current problem and the need for immediate action, the Association wants to voice support for a court structure that will allow for a single forum unhampered by jurisdictional distinctions in which a debtor all creditors, and all parties in interest could expeditiously assert claims and establish their rights and responsibilities. This type of structure is necessary to administer most effecitvely the large commercial proceedings. We believe only an Article III bankruptcy court can accomplish this objective.

A single forum approach enhances the possibility that the collateral disputes surrounding the affairs of a troubled debtor can be resolved quickly and uniformly, with a minimum of economic dislocation through forum shopping, litigation expense, and delay. Until December 24, 1982, our experience with the single forum approach under the new Code had been favorable. In many cases, problems or proceedings that could not be resolved cost-effectively in state courts or other federal courts could be disposed of quickly in the bankruptcy court.

We also believe that Article III status for bankruptcy judges is essential to attract and retain on the bench qualified and experienced people. A broad jurisdictional grant and life tenure help to make a position more interesting and attractive, thus stimulating more competition for the position.

We also urge this Subcommittee to provide the Article III judges with the salary and emoluments necessary to make the position attractive. The bankruptcy court should have sufficient staff and clerical support to administer effectively their caseload.

We would also urge this Committee as it considers the number of judges and the officers and magistrates necessary to operate the courts to consider the need for adequate personnel to deal with the large number of no asset, and low asset consumer and Chapter 13 cases. These cases represent the large majority of filings but often receive only minimal attention in administration by the court.

Consumer Amendments

Mr. Chairman, shortly after the enactment of the 1978

Bankruptcy Code, it became apparent that the new law contained provisions which removed most of the disincentives to filing bankruptcy. In fact, the rapid, unprecedented and substantial rise in the number of filings which began shortly after the enactment of the 1978 Code indicates that the system may in fact encourage individuals to resort unnecessarily to bankruptcy. This Association, in conjunction with numerous groups, that represent virtually every other class of consumer creditor in this country, requested the Credit Research Center at Purdue University to analyze what was perceived to be a serious and growing problem.

The results of that study showed that a significant number of individuals, who are using the bankruptcy system to obtain a discharge of their debts, are in fact far from "financially destitute", and in many cases would have been able to repay most or all of their debts out of their disposable income accrued over a 3-5 year period.

This Association has submitted detailed testimony on a number of occasions that addressed the question of the appropriateness ofan individual employing the advantages of the bankruptcy system as described above. In addition, this Association is on record for having testified to a number of other problems with the Code which our members began to encounter shortly after it was enacted. These past hearings ultimately led to the introduction in this Senate by you, Mr. Chairman, of S.2000, "The Bankruptcy Improvements Act of 1981". Despite the favorable report by this Committee of S.2000 and the widespread recognition of the bankruptcy problems, no bankruptcy legislation was enacted during the last session of Congress.

The failure of the 97th Congress to enact the provisions of S.2000 is in no way indicative of a change of circumstances within the consumer credit industry. The problems, Mr. Chairman, unfortunately have not changed nor have they gone away. Many of our members are still faced with a record number of bankruptcies and increased dollar losses due to bankruptcy filings while overall delinquncies are down. Rather than simply repeat our past testimonies before this Subcommittee, I will summarize our concerns with respect to the consumer provisions of the Code.

Inappropriate Exercise of the Bankruptcy Discharge

Foremost in the minds of all creditors is the inappropriate exercise of the bankruptcy discharge by those who are not truly in need of this type of "last resort" relief. The Purdue study findings referred to earlier are discussed in detail in the testimony of Mr. Robert Evans, who is testifying before you today on behalf of the National Coalition for Bankruptcy Reform. In short, that study shows quite conclusively that there is significant exercise of the bankruptcy discharge by those who possess the ability to repay some or all of their debts without hardship. The need for an immediate legislative correction is urgent. The nature of the problem we are facing makes it certain that these problems will continue or perhaps accelerate due to the inability of creditors to identify and therefore avoid potential bankrupts.

The current bankruptcy rules make potential bankrupts virtually "invisible" to creditors on the basis of the best credit evaluation systems that the credit industry has been able to devise. In a significant number of cases, literally the day before a consumer files a petition for bankruptcy, the consumer would most likely be considered by the best credit scoring systems and judgmental evaluation approaches as being creditworthy and, indeed, entitled to additional credit.

To demonstrate the magnitude of this problem, one large West Coast bank studied a random sample of 320 bankruptcy cases. Based on a review of the bank's files, between 18% and 30% of those who filed would have been entitled to obtain additional credit the day before they filed. Thus, about one in four of those who filed, the day before they did so, appeared to that bank's credit scoring system as good credit risks, with high credit ratings - consumers to whom that bank or most other creditors would have given more credit. How can the banking industry distinguish those credit applicants from the others who seek and want credit and choose to repay it?

Because the new Act removed virtually all disincentives to filing, the cases we are experiencing now are not of the same type that we used to see under the old Bankruptcy Act. Those cases generally involved persons who were suffering the effects of unemployment or economic difficulties or health problems. Today, however, they are consumers who, by all criteria, were creditworthy when credit was extended and continue to be creditworthy despite the fact that they have a federal mechanism available for shedding their debts. The study by the Credit Research Center at Purdue University revealed that in more than 78% of the households that filed for bankruptcy -- almost four in five -- there was a member who held a full-time job. This illustrates the changing nature of the cases being filed in the bankrupcy courts.

The long-term implications of this problem are clear. If the credit community was able to identify those who are in difficulty or who may be headed for difficulty, it would then be a simple enough task to simply refuse to grant them credit. This means that the bankruptcy system has created the potential for persons who have affordable debt reflected by reasonable debt structures to take advantage of that system notwithstanding their economic ability to meet their obligations.

We recognize the need of the "fresh start" the bankruptcy discharge provides for the majority of Chapter 7 petitioners. We, however, also recognize the need to limit accessibility to a Chapter 7 discharge only to those who truly need it, and not to those who are merely seeking an easy way out of an uncomfortable debt structure.

Confirmation Standard Under Chapter 13

Chapter 13 of the Code offers the debtor the incentive of being able to keep all his assets in exchange for payments to the court which are then distributed to creditors over a period of time. However, the Code is not clear on how much effort the debtor must put into the repayment plan. Some courts are allowing debtors to make only minimal payments over short periods of time while in other courts the plans work extremely well in returning a large part of the debts involved to creditors.

The present Code requires that a Chapter 13 plan must be proposed in "good faith" or the court will not approve it (Section 1325(a)(3)). But this "good faith" standard has been interpreted, by some courts, to require deliberate fraud of creditors before a plan is rejected. Confirmation of minimal repayment plans are allowed by these courts even though the debtor's income would support a much more substantial payment.

The Association believes that the intent of Chapter 13 should be to require a substantial effort on the part of the debtor to pay his debts. The Code should be amended to provide that all of the debtor's income, over and above that which is necessary to support the debtor and his dependents, should be devoted to the plan.

Time Period for Chapter 13 Plans

In addition to the confirmation standard, the time period for the Chapter 13 plan should also be tailored to meet the debtor's ability to pay. Since maturities of many consumer debts often exceed 36 months, it makes sense to expand the time for repayment under Chapter 13. This expanded time period would allow added flexibility to reduce monthly payments and extend payment schedules thus increasing the feasibility of the plan.

The consumer credit industry proposes that 5 years be implemented as the normal plan period. A shorter time period should be authorized only if the plan pays a substantial return to unsecured creditors in the shorter period.

Enforcement of Secured Claims

When the debtor files a petition in bankruptcy, the debtor often has in his possession property which is security for his debts - most frequently an automobile. The debtor generally has several options with respect to such property. The debtor, in some cases, may redeem the property by paying the creditor the value of the property or the amount of the debt, whichever is less. If the court allows, the debtor may reaffirm all or part of the debt. In other words, the debtor agrees with the creditor to allow him to keep the property in exchange for payments to be made after the discharge. Finally, the debtor may surrender the property to the trustee or, if the trustee asserts no interest in the property, he may surrender the property to the creditor.

When an individual files a petition in bankruptcy, the creditor has no satisfactory means of determining which of these options the debtor will exercise. The debtor, taking advantage of a crowded court docket and the inherent delays in the bankruptcy process may often continue to use the property for up to six months or longer. During this time the property may rapidly depreciate in value. This depreciation may be aggravated by the fact that the debtor may not properly maintain or insure the property. The automatic stay prohibits contact with the debtor by the creditor to resolve this question. An adversary proceeding in the bankruptcy court to resolve the issue would generally cost at least $500 and perhaps considerably more if several court appearances are required.

The Association recommends that the Code be amended to require that the debtor disclose his intention with respect to secured collateral either at the time the petition is filed or early in the proceeding. The debtor should then have a limited period of time to perform his stated intention. If the debtor does not perform upon his stated intention, the automatic stay should expire and allow the creditor to pursue normal commercial and court procedures to obtain the property.

Dischargeability of Fraudulent Debts

Creditors and particularly credit card issuers have recently experienced a number of cases of "loading-up" - cases where the debtor goes on a pre-petition buying spree using a credit card or other unsecured line of credit which is then discharged in bankruptcy.

These buying sprees are difficult to detect and stop because of the short time period involved and are difficult to challenge as a fraudulent debt in bankruptcy court. To prove that a debt was fraudulently incurred, the creditor must show that each purchase was made with the "intent" to defraud the creditor. Because the creditor has not met face to face with the debtor, the creditor must show this intent based on circumstantial evidence surrounding the use of the line of credit. This difficult burden makes it very risky to challenge a discharge particularly when a losing creditor would be required to pay the debtor's attorney fees unless it would be "clearly inequitable" for the court to make such an award. (Code Section 523(d)).

The Association supports addition of a rebuttable presumption in the Code that a debt incurred within a short time of the petition is nondischargeable. Further, an award of attorney's fees to the debtor should not be given unless the court determines that the creditor was not acting in good faith by challenging the discharge of a debt.

Mr. Chairman, these are some of the major concerns of the Association with the 1978 Code. We, however, are fully supportive of all of the corrective measures which were contained in S.2000. While we have not attempted today to cover all of the areas which we feel merit attention, we would refer you to the Committee Report on S. 2000 for a more complete analysis of the issues. Senate Report Number 97-446 details the conclusions of the Senate Judiciary Committee after their consideration of the consumer bankruptcy problem. It represents a cogent and concise analysis of the problems and some suggested solutions.

The Association feels that these solutions proffered by S.2000 represent a responsible and equitable way to resolve the consumer bankruptcy problems.

While the Association is supportive of the solutions suggested in the report on S.2000, we do not feel these are carved in stone and would certainly welcome the opportunity to discuss alternative approaches should the Committee feel they would expedite resolution of these issues.

Whatever the approach taken by the Committee, it is imperative that this legislation be enacted at the earliest possible moment. There has been no respite in the onslaught of filings. We urge the Senators of this Committee to act quickly to stem this tide of bankruptcy petitions, the cost of which is ultimately borne by the responsible bill-paying consumer.

III. Grain Elevator Bankruptcy

This Association had strong reservations about the grain elevator bankruptcy provisions as they were initially proposed in the 97th Congress. Several provisions in the original bill called into question the continued participation of banks in providing financing for grain storage facilities and for farmers. However, S.3037 that passed the Senate in October, addresses our major concerns. We are grateful to you Mr. Chairman for the consideration of our concerns. We can now be supportive of this measure, and particularly, implementation of expedited proceedings to determine interests in grain stored in elevators as provided for in that bill.

IV. Repurchase Agreement Amendments

In September, 1982 and again in December, 1982, the Board of Governors of the Federal Reserve System (Board) submitted proposed amendments to the Code to this Subcommittee dealing with repurchase transactions.

This Association supports the amendments proposed by the Board. We believe that the amendments are necessary to insure a favorable environment in the financial market for certain types of financial instruments particularly government securities.

In conclusion, we want again to emphasize the immediate need for bankruptcy legislation. This Subcommittee should be commended for holding these hearings at this early date. The costs and delays in the bankruptcy courts cannot continue for long without potentially tragic results. The need for consumer bankruptcy reform is definitely clear and pressing. We thank the Subcommittee for their attention to these matters and urge the entire Congress to address these issues without delay.

We thank you for the opportunity to make our views known.

PREPARED STATEMENT OF DONALD BEALL

Good day. My name is Donald Beall. I am manager of the NASA Federal Credit Union, Riverdale, Maryland, and chairman of the Credit Union National Association's Task Force on Bankruptcy.

The Credit Union National Association, Inc. (CUNA) represents more than 20,000 of the nation's state and federally chartered credit unions through 52 member credit union leagues. These leagues are located in each of the states, the District of Columbia and Puerto Rico. America's credit unions serve more than 47 million citizens.

The issue before this body today is not new. I have had the opportunity to testify twice before on the need for consumer bankruptcy reform. The losses which we brought to your attention over the past 24 months that we have determined are attributable to provisions of the Bankruptcy Reform Act of 1978 continue at record levels. Although the economy and other factors continue to contribute to the volume of bankruptcies, it is clear now that abuse of the Code does exist to a substantial but, we believe, remediable degree.

Moreover, our bankruptcy experience has forced credit unions, like NASA Federal Credit Union, to alter their traditional lending practices. At my own credit union, we have determined that the cost of bankruptcy translates into an additional 1% in the interest rate that my members must now pay to borrow. In addition, we are emphasizing our home equity lending plan as an alternative to the traditional open-end credit plan because real estate collateral offers greater protection to the credit union should things go wrong.

The President, Congressional leaders and economists are all looking for the consumer to lead the way out of this economic downturn. Increased consumer spending depends, in part, on the willingness of lenders like the nation's 20,000 credit unions to provide the funds for automobiles, washing machines, refrigerators, boats, trailers and a host of other items that are available, affordable and desired by our members. We have the liquidity to fill these needs. However, in the future credit will be extended not just on the basis of the 3 C's -- character, collateral and capacity. We've added a new consideration -- bankruptcy. As I have said, its impact pervades every aspect of the credit-granting process. From reduced availability of certain types of credit to increased cost of all types of credit, our message has been constant -- the personal bankruptcy cases that clog the courts do not all belong there, and adoption of the package of consumer amendments can help reduce them, to the benefit of all.

These amendments will not deprive any needy debtors of the fresh start that our nation's bankruptcy laws promise. Instead, they simply make bankruptcy less vulnerable to those who now use it to obtain a "head start."

In the months since I last testified before this body, a new crisis has arisen. In the Marathon decision, the Supreme Court struck down the constitutionality of the court system provided in the 1978 Bankruptcy Reform Act. This nation can ill afford a lengthy delay in the legislative restructuring of the court system to meet constitutional objections. I am not an attorney, but I participated in the conference conducted by Senator DeConcini on the bankruptcy crisis. I believe it is real. In the commercial area I believe the consequences could be staggering. The uncertainty of the interim rules proposed by the Administrative Office of the United States Courts threatens work-out plans already in effect under Chapter 11 and draws into question the availability of Chapter 11 relief for those industries experiencing temporary, not terminal, financial difficulty.

CUNA actively participated in and endorsed the work of the Presidential commission leading to the bankruptcy reform of 1978. We recognize the desirability of a bankruptcy court system able to resolve all questions related to bankruptcy in a single proceeding.

The critical issue, however, is how to quickly resolve the current crisis in the bankruptcy court system. At the earliest opportunity after the Supreme Court's December 24th stay expired, CUNA filed a brief with the Supreme Court in the Alabama Furniture Co. vs. Rivers case urging the court to grant certiorari and review its Marathon decision and the interim rules proposed by the Administrative Office of the United States Courts. It was our feeling that a court ruling on the constitutionality of the rules would eliminate future challenges to the authority of bankruptcy courts under the rule, pending full Congressional review of the bankruptcy court issue.

Although the Court declined to take the case, our participation remains a clear sign that we are committed to a speedy and workable resolution of this issue.

There are several alternatives now available to the Congress. First, the interim rules could be adopted legislatively indicating Congress' clear endorsement. The legislation could include a sunset provision to allow Congress sufficient time to debate all the issues surrounding the structure of the bankruptcy court system.

Second, Congress could create a system of bankruptcy judges under Article I of the Constitution, and finally, the Congress could make all bankruptcy judges officers of the court under Article III of the Constitution.

The resolution to the Marathon issue is not incompatible with action on the consumer bankruptcy provisions. Both are vital to the economic well-being of the nation. On the one hand, a bankruptcy court system that is clearly constitutional will create the certainty that commercial bankruptcies require under Chapter 7 and Chapter 11. On the other hand, the consumer bankruptcy reform amendments are essential if credit unions and other lenders are to be convinced that a growing number of consumer/borrowers do not look to bankruptcy as the way to control monthly payments.

I do not believe it necessary, at this time, to dwell on the specifics of the consumer bankruptcy amendment package that have been debated by this Committee for more than two years. CUNA's previous testimony on these amendments is attached to this statement, and I wish it made part of this record.

It is my personal feeling, as well as that of the Credit Union National Association, that resolution of the crisis in the bankruptcy court system and adoption of the consumer bankruptcy amendments are critical to the nation's ability to weather the current economic recession. We are convinced that prompt legislative action by the Senate and the House of Representatives will reduce the uncertainty surrounding the jurisdiction of the bankruptcy courts after the Supreme Court's Marathon decision. Adoption of the consumer bankruptcy amendments will also increase the likelihood that credit costs can be reduced and credit made more available to meet consumer demands.

STATEMENT OF THE CREDIT UNION NATIONAL ASSOCIATION (CUNA)

Good Morning. My name is Eldon Hoekstra from West Linn, Oregon. I am Secretary of the Credit Union National Association, Inc. (CUNA) and Chairman of CUNA's Bankruptcy Task Force. Joining me today is Donald Beall, Manager of the NASA Federal Credit Union, Beltsville, Maryland, and Vice-Chairman of CUNA's Bankruptcy Task Force.

The Credit Union National Association represents more than 20,000 of the nation's state and federally chartered credit unions through 52 member credit union leagues. These leagues are located in each of the states, the District of Columbia and Puerto Rico.

ROLE OF CREDIT UNIONS

Credit unions are member-owned cooperative financial institutions. Membership is limited to persons within a field of membership, generally employment, associational or geographic in nature. Credit unions are democratically controlled with each individual member of the credit union having one vote, regardless of the number of dollars on deposit at the credit union. As democratically controlled financial cooperatives, the consumer orientation of these institutions is ensured. These unique financial institutions return every penny of income earned in excess of operating expenses and required reserves to their owner/members. More than 45 million consumers have joined credit unions because they offer loans at reasonable rates and offer a high rate of return on member savings.

Helping to provide for each member's total financial well-being through the credit union does not end with merely lending other members' funds to consumer/members and providing a fair rate of return on savings. A fundamental concept of a credit union, carried through in practice by these consumer cooperatives of today, is consumer financial counselling. Self-help, coordinated through the credit union, is the best method of ensuring the credit union member's financial well-being.

Last year CUNA launched a major program aimed at providing all credit unions, regardless of asset size, with the tools to assist members in providing for their own financial security. The program, called "Financial Fitness," was designed to allow each credit union to better fulfill its role as the complete financial advisor as well as lender and depository to each credit union member. The well received program has resulted in a rededication by the credit union movement to this essential purpose of the more than 20,000 consumer financial cooperatives.

BANKRUPTCY'S IMPACT ON CREDIT UNIONS

Consumers, including credit union members, can experience extreme financial difficulty for a variety of reasons. Loss of job, medical emergencies, marital difficulties and the inability to handle consumer credit responsibly are among the most frequent reasons cited by those who seek the relief of the bankruptcy courts.

Each personal bankruptcy represents a major, long lasting setback for the consumer and the family involved. The loss does not stop there. Each time a petition of bankruptcy is filed and notice received by a credit union, a loss will eventually be transmitted to each of the consumer's fellow credit union members. The cost of that petition of bankruptcy to those credit union members is not just an increased cost of credit or a reduction in the amount of credit available; the loss results in a direct reduction of the value of the members' equity in the credit union and reduces each member's potential return.

CUNA firmly believes in and remains committed to providing relief from debts through bankruptcy for those who have no other alternative but bankruptcy. Bankruptcy, however, should be a last resort. As a result of the changes in the Bankruptcy law made in 1978, CUNA submits that the present law is no longer a last resort.

Bankruptcies, under the new Code, have skyrocketed. Credit unions throughout the nation have reported not only an alarming increase in the number of bankruptcies, but also reported that in many instances consumers are using the liberal provisions of the new Bankruptcy Code to escape debt which they are able to pay.

I am here today on behalf of CUNA to request that the Senate review the Code. I believe that a full and fair exploration of the operation of the Code will bring the Congress, as it has the credit union movement, to the recognition that changes must be made in the Code to make it more equitably balance the true consumer need for relief from debt with the right of credit union members to the return of their funds.

SCOPE OF PROBLEM

Credit unions have experienced a dramatic upswing in the number of bankruptcies affecting them since the Code became effective 18 months ago. Two surveys have been conducted to document the problems bankruptcies have been causing credit unions. We would like to share the results of these surveys with the Subcommittee.

Late last year the Defense Credit Union Council, with membership of about 400 military-based credit unions, surveyed its members on bankruptcy. The information in Tables I and II was received from 146 defense credit unions:

TABLE I

Notices of Bankruptcies

	Total Number	% Increase from Previous Year	Total Dollar	% Increase from Previous Year
Oct 77-Sep 78	4,521	---	7,501,047	---
Oct 78-Sep 79	5,521	22.2%	9,926,338	32.3%
Oct 79-Sep 80	9,292	68.3%	18,106,162	82.4%

TABLE II

Loan Losses Written Off

	Total $ Losses	Bankruptcy $ Losses	% of Losses Due to Bankruptcies
Oct 77-Sep 78	25,894,347	4,939,225	19.1%
Oct 78-Sep 79	32,062,752	6,650,263	20.7%
Oct 79-Sep 80	39,290,924	10,521,769	26.8%

In the year following the implementation of the new law, bankruptcy notices received by this group of credit unions increased 68 percent, and the dollar value of the credit union loans of the debtor filing bankruptcy increased 82 percent. Bankruptcy loan losses as a percentage of total loan losses increased from 19 percent to 27 percent during the recent three-year period, an eight percent increase, with six percent of the increase coming in the 12 months following the effective date of the Code. The survey also reported that only 5.5 percent of those members filing bankruptcy notices have subsequently agreed to repay their credit unions.

While some of the last year's increase might be a result of debtors waiting to take advantage of the liberalized Bankruptcy Code provisions, these figures showing the jump of bankruptcies at defense credit unions are particularly noteworthy because these credit unions have a field of membership drawn from the stable employment group of military personnel and their families. Although this group has suffered from the inflationary pressures faced by all workers today, the military has job security and fringe benefits, such as medical care, which help protect against most personal financial crises, a traditional reason for declaring bankruptcy in the past.

CUNA conducted a survey early this year to get information on member bankruptcies. Credit unions were asked for data going back to 1974 to try to determine how bankruptcies in the recessionary period of 1974 compared with bankruptcies during the recessionary period of 1980. A questionnaire was mailed to all credit unions, and a total of 1,452 responses were received. Although the responses were fairly representative of the asset distribution of credit unions, since the survey was not a random scientific sampling, an extrapolation of the data to draw conclusions about the impact of bankruptcies on all credit unions is not possible. However, it should be noted that over 40 percent of the credit unions responding had no bankruptcy notices in 1980, so the respondents were not just credit unions experiencing problems. Table III on the next page summarizes the impact bankruptcies are having on the credit unions reporting.

Although the number of credit unions receiving bankruptcy notices grew between 1974 and 1979, the growth rate was not statistically significant. However, the number of filings jumped in 1979-1980 and is statistically significant. About 60 percent of the reporting credit unions in 1980 were impacted by consumer bankruptcies. In this six-year period, the number of credit unions reporting bankruptices increased two and one-half times. The number of member bankruptcies at the typical credit union reporting any bankruptcies more than doubled from 7 members in 1974 to 14 members in 1980.

The credit unions also reported information on the dollar amount of bankruptcies affecting them which allows for a calculation of the average dollar size of a bankruptcy affecting a credit union. This could be viewed as the average loan balance a debtor filing bankruptcy had with a credit union at the time of bankruptcy. There was a drop in the average amount between 1974 and 1975, a fairly steady rise up until 1979 when the figure reached $1,958, and a significant increase in the dollar value of bankruptcies in 1980 when the average loan balance jumped to $2,659.

Reaffirmations have always been very important to credit unions because of their unique cooperative structure. Table IV reflects the reaffirmations reported over the six year period in 1974-1980 by those credit unions having such information.

TABLE III

Notices of Bankruptcies

	# of CUs Reporting At Least One Bankruptcy Notice	% of Total CUs Reporting (Column 1/ 1,452)	Mean # of Bankruptcy Notices at CUs Receiving Any Notices	Mean $ Amount of Bankruptcy Notices Received by CUs	Average $ Size of Bankruptcy Affecting CUs (Column 4/ Column 3)
1974	307	21.1%	6.77	12,254	1,810
1975	353	24.3%	8.22	13,259	1,613
1976	425	29.3%	8.89	14,505	1,632
1977	469	32.3%	9.13	15,868	1,738
1978	518	35.7%	9.80	18,637	1,901
1979	620	42.7%	11.24	22,000	1,958
1980 (Nov)	841	58.6%	14.68	38,993	2,659

Table IV
Reaffirmations

	No. of CUs Reporting	Mean Reaffirmation as % of Bankruptcy Notices
1974	82	58.6
1975	95	56.9
1976	118	61.1
1977	130	62.0
1978	142	56.2
1979	211	54.6
1980 (Nov)	354	42.5

The table shows a dramatic decline in reaffirmations in the last year--from 54.6 percent of bankruptcies in 1979 to 42.5 percent in 1980.

The survey also indicated the growing significance bankruptcies are having to credit unions' loan losses, from credit unions having the data to supply this information:

Table V

Loan Loss Charge-Offs

	No. of CUs Reporting	% of Dollar Amount of Charge-Offs Attributed to Bankruptcy
1974	235	37.0
1975	296	40.8
1976	346	41.6
1977	366	39.6
1978	415	36.4
1979	496	39.4
1980 (Nov)	640	56.0

In 1974 the dollar loss attributed to bankruptcies was 37 percent of total losses suffered by the reporting credit unions. In 1980 losses from bankruptcy account for 56 percent of total losses and this was a significant jump in the percentage between 1979 and 1980.

These alarming numbers of bankruptcies filed and the dollar amount of losses incurred resulted in the formation of the CUNA Bankruptcy Task Force. The mission of the Task Force is to encourage legislative changes to improve the Bankruptcy Code and to supervise the development of a package of aids designed to assist credit unions in minimizing bankruptcy-related losses and to educate members on the ramifications of bankruptcy. The Task Force has been chosen to represent both large and small credit unions, and selected because of their familiarity with the problems encountered both within their own credit unions and throughout the industry.

CUNA TASK FORCE--ISOLATION OF CAUSES OF BANKRUPTCY

Bankruptcies filed by credit union members affect all members of a credit union. CUNA takes the position that, for those members for which there is no other relief, bankruptcy must be preserved as a method of obtaining a fresh start.

In examining the causes of increased bankruptcy, our Bankruptcy Task Force isolated five basic causes for the increase in the number of bankruptcies. These are: (1) lawyer advertising; (2) changing social attitudes about bankruptcy; (3) the economy; (4) creditor lending criteria based on future income rather than on assets and liabilities; and (5) the new bankruptcy law.

The impact of lawyer advertising and the changing social attitudes about bankruptcy are best dealt with through frank member education. Members must be counseled that declaring bankruptcy does not result in a better credit rating. Bankruptcy merely allows a consumer to "start over" again and permits the consumer to begin again to live within his means. The bankruptcy is carried on the consumer's credit record for a period of 10 years. The consumer may well have to spend the 10-year period as a "cash customer," reestablishing creditworthiness. The credit union remains available to the member declaring bankruptcy as a place to save. Eventually the member may warrant member trust and confidence in the form of a loan of the funds of other members.

The fresh start of bankruptcy does not automatically mean that creditworthiness has been reestablished. Unfortunately, many consumers are led to this belief by misleading statements holding bankruptcy out as a way to get rid of all debts without mention of the significant and far-reaching consequences of declaring bankruptcy.

CUNA's Task Force has also considered the impact of the economy on the increased rate of bankruptcies being filed involving credit unions. We recognize that the rate of inflation is a significant factor in the increased difficulties consumers are having meeting their obligations as they come due. However, our survey (see Table III) demonstrates that there is a significant difference between the number of bankruptcies filed in 1974, representing the country's earlier recessionary period, and the number filed in 1980, the recent period of economic stress. The two and one-half times more bankruptcies filed in 1980 as compared to 1974 indicates that the economy alone is not to be blamed. Further, personal crises, such as medical bills or loss of employment, cannot explain the significant increase in the number of bankruptcies filed involving military personnel whose jobs are secured and medical bills paid.

In a similar vein, there is no correlation between the number of bankruptcies filed involving occupational-based credit unions with economic difficulties and other occupational credit unions with stable sponsor employment.

The new Bankruptcy Code is not the sole reason for the increased number of bankruptcies being filed involving credit union members which creates losses affecting assets of other members. The Code, like many new laws, needs adjustment, not radical change. With this understanding CUNA's Task Force has reviewed not just the theory of the Code, but its practical operation.

CUNA TASK FORCE--AREAS OF CHANGE

Today, I would like to present the findings of that Task Force with regard to its legislative recommendations for improving the sweeping 1978 revision of the bankruptcy law.

CUNA, in making legislative recommendations for change in the Bankruptcy Code, is speaking on its own behalf. We have consulted extensively with representatives of other financial institutions and lenders. We share their alarm and concern at the increased number of bankruptcies being filed. However, although there is a significant amount of agreement on the general parameters of changes needed, the specific changes needed are not unanimously agreed upon. CUNA hopes to work with the Senate and the House in fashioning a legislative package that best resolves the difficulties being encountered with the 1978 Code.

The CUNA Task Force identified a number of specific problem areas for credit unions:

-- Consumer/members who can afford to repay debts are using the liberal provisions of the new Code to escape debt.

-- Members who in the past have reaffirmed their debts are prevented by the courts from doing so.

-- The legal procedures required in consumer bankruptcies are inefficient. Courts and creditors do not have adequate information on the financial condition of the debtor and his or her intention with respect to the collateral. The first meeting of creditors is not structured to resolve disputed matters promptly.

-- The valuation of collateral and the exemptions provided by the Code actually give a "head start."

-- The preference provisions do not allow for payments received in the ordinary course of business.

-- Chapter 13 plans do not always require a debtor's best effort, the length of plans are not sufficient, and repayments do not begin promptly.

Having identified these areas of concern, the Task Force set out to identify and justify possible legislative remedies that better balance the needs of the credit union in bankruptcy proceedings with the need for consumer protection where bankruptcy relief has been sought. These specific recommendations are discussed below.

I. THRESHOLD TEST.

CUNA submits that the major shortcoming of the 1978 Bankruptcy Code as it applies to consumer-debtors is its failure to accurately reflect the basis of consumer lending over the past 30 years. As enacted, the Code permits a consumer to file bankruptcy when the consumer's assets are less than his or her liabilities.

Credit unions, as consumer cooperative financial institutions, have never engaged in balance sheet lending. It is fundamental to credit union lending that loans are granted on the ability of the member to repay that loan from his or her major asset--future income. The Code ignores this fundamental principle of credit union lending by granting bankruptcy relief without precondition, and then limiting the credit union and its member/owners to a pro rata share in the liquidation of a credit union "debtor's" assets.

While this principle of relief may serve the commercial market well, it is at odds with every principal of credit union lending.

The original Bankruptcy Act, of course, employed the same principle of granting relief on a simple assets and liabilities test. The hearings on the Code suggested that most consumers invoked bankruptcy relief because of unforeseeable events. CUNA has stated consistently that where a personal calamity, such as illness or job lay-off, is involved, bankruptcy relief is and should continue to be available to those consumers.

However, evidence now being developed which shows that many consumers seeking bankruptcy relief today could afford to pay more of their debts than their counterparts under the Act. This greater ability to pay these debts may come from an increased income to debt ratio or from the ability to exempt greater amounts of property, thereby freeing up future income for other purposes. The ability to pay debts was, in the final analysis, the reason the original credit was extended.

Bankruptcy relief must not be available merely for the asking. The court, sitting in equity, must have the authority to explore not only the debts and the assets of the consumer, but also consider the consumer's most important asset--income. The Bankruptcy Act of 1978 does not instruct the court to make this consideration. In fact, most judges have interpreted the Act to preclude them from making this type of consideration in determining whether or not a consumer qualifies for relief under the Bankruptcy Act. In some instances the relief provided in Chapter 13 may be more equitable to the consumer and the creditors than that of Chapter 7. The present law provides the judge with little or no discretion to fully exercise the equity jurisdiction vested in the court.

It is CUNA's belief that the bankruptcy court must be given flexibility to consider the consumer's entire financial statement in fashioning the relief. It is not enough that the consumer, or the consumer's attorney where represented by counsel, has selected a particular form of relief. The court needs the ability to fashion relief which balances the needs of all parties to the proceeding. We strongly urge the Congress to adopt a "good faith" test for eligibility for bankruptcy relief.

It is our belief that the good faith test should be added to Chapter 7 so that where a judge, after reviewing the entire financial statement of the consumer, might find that Chapter 7 relief is not in the best interests of all parties, and thereby encourage the debtor to seek financial counselling or the relief available in Chapter 13.

A very important protection to the discretion we are advocating for bankruptcy judges could be found in a definition of good faith that would specifically encourage the judge to look not only at the assets and liabilities of the consumer, but also the income--or expected income, the maturity and repayment schedules of debts and other factors. In other words, we believe the judge should be able to consider the entire financial picture of the consumer.

CUNA is not suggesting a "mandatory Chapter 13" form of relief. It is our belief that the addition of a good faith test will merely encourage debtors to more carefully scrutinize their ability to repay debts before seeking bankruptcy relief.

We are convinced that the work of the bankruptcy courts will not increase as a result of the addition of a good faith test. Debtors and, if used, their attorneys will quickly accommodate the addition of a "good faith" test in their own analysis of the form of relief to be sought. Where the consumer's income has not been interrupted and the debt ratio will support payments, non-judicial relief or relief under Chapter 13 will be selected before a petition is filed. Contested cases will only arise in those situations that clearly do not warrant relief under the straight liquidation proceeding offered under Chapter 7.

II. REAFFIRMATIONS.

The 1978 Bankruptcy Act made sweeping changes to the reaffirmation provisions that exist under the old law. These changes were the outgrowth of findings by the Bankruptcy Commission that reaffirmations sometimes were obtained through unfair means that undermined the purpose of bankruptcy relief.

Credit unions were dramatically affected by these changes as were all other lenders. In fact, credit unions, for good reason, had always experienced a high rate of reaffirmation. As member-owned cooperatives, consumers who borrowed from their credit union have always felt an extremely deep obligation to repay credit union loans because they were in fact the funds of other members who were frequently neighbors, fellow employees or parishioners.

The underlying rationale for the change in reaffirmation notwithstanding, the simple fact is that the change has made a significant difference in the losses experienced by credit unions due to bankruptcy. Reaffirmation of unsecured loans has been difficult to obtain through the bankruptcy courts due to the present standard of "best interest of the debtor." In secured loan situations, such as automobile loans, the value set on the property by the court is frequently much lower than the amount owed on the loan. Redemption, not reaffirmation, is generally sought by the debtor's lawyer in these cases.

CUNA believes the existing Code provision on reaffirmation "throws the baby out with the bath water." We would suggest modification to allow the consumer greater ability to reaffirm debts. We believe the abuses of the past can be prevented and the consumer-debtor protected by allowing a reaffirmation only upon explanation of the consequences to the debtor by the credit union prior to reaffirmation and with a rescission allowed any time prior to discharge or within 60 days of the reaffirmation, whichever occurs later. This proposal would avoid the necessity of going to court to secure reaffirmation. The expense of counsel fees and court appearances to both the consumer and the credit union should be avoided wherever possible.

III. IMPROVING THE PROCESS OF CONSUMER BANKRUPTCIES.

The following describes areas of the present bankruptcy process that require legislation to make the bankruptcy proceeding more efficient.

A. Duties of the Debtor.

Credit unions have experienced a constant problem throughout the country under the new Code in not knowing what property the debtor has in his or her possession and what the debtor intends to do with the property. Invariably, when the debtor begins a bankruptcy proceeding by filing a petition, the security for any consumer debt is in the hands of the debtor. While this should be turned over to the trustee, in almost all circumstances the debtor ends up, for instance, driving the automobile for the length of time the court takes to act upon the petition.

The automatic stay provisions of the Code prevent the credit union from contacting the debtor to inquire about the debtor's intended action with regard to property. The debtor and the trustee have a number of options, including redemption, abandonment, or surrender of the collateral, as well as reaffirmation.

CUNA suggests that it is in the best interests of the efficiency of bankruptcy proceedings to require the debtor to state his or her intention with regard to property securing a loan within a short period of time after filing the petition. This should be done prior to the first meeting of the creditors so that the credit union may better prepare itself to participate in that meeting. Further, to facilitate the smooth functioning of the bankruptcy process, the automatic stay should be lifted and contact permitted in this limited regard if the debtor fails to state his or her intention with regard to the disposition of collateral within the time allowed after the filing of a petition.

The requirement should not be burdensome to debtors since they control the timing of the filing of the petition and must also make a basic determination as to which assets they wish to protect and how they intend to dispose of collateral. The earlier in the process this is accomplished, the more efficient the bankruptcy proceeding and the speedier the relief afforded the debtor.

Another way to make the bankruptcy process more efficient would be to require the debtor to file a more complete picture of his or her financial condition in the initial petition. In addition to merely filing assets and liabilities, the debtor should file a statement that sets forth the debtor's current income, the regularly scheduled installment payments, living expenses, other outstanding noninstallment debts, any reasonably expected windfall income, and expenses reasonably expected within the immediate future. A copy of the petition should also be served upon each scheduled creditor.

The purpose of adding this information to the current petition is to provide both the court and creditors with a complete picture of the debtor's financial condition. This would enable a credit union to better evaluate the need to participate and bear the expense of attorneys at the first meeting of creditors. The vast majority of cases would probably be simplified by increasing the information available to all parties. Further, most debtors currently prepare this information before seeking relief through the bankruptcy process, even where they are appearing without advice of counsel. Requiring the additional information should not be a burden to debtors, as the information is already in their hands.

B. Meeting of the Creditors.

CUNA suggests that the essential speeding of the process can be accomplished by having the bankrutpcy judge convene the first meeting of the creditors. The innovation in the Code called for the trustee to handle the majority of the bankruptcy proceeding with the judge being present only at the discharge hearing. This was done to allow as much of the negotiation as possible to be done outside the bankruptcy court. However, in practice, the trustees have generally discouraged participation in the first meeting of creditors by nonlawyers which has placed a great burden on small businesses such as credit unions. In all cases of controversy, a complaint must be filed requiring unnecessary court fees and delays.

The purpose of having debtors file a more complete personal financial statement and declare intentions with regard to collateral securing loans early in the process is to permit rapid determination of disputed issues early in the process. Presently, delays of up to one year in achieving payment and disposition of the collateral have not been uncommon. By having the judge convene the first meeting, all matters in dispute could be brought before his attention at that time and resolved.

CUNA does not believe the presence of the judge at the initial meeting will increase the work of the bankruptcy judge. The judge will be called upon to hear only those matters which would otherwise have come to his attention. The presence of additional information concerning the financial picture of the debtor and the intent with regard to collateral will greatly facilitate the resolution of disputes prior to the first meeting of creditors. If the judge is present and convenes the first meeting of the creditors, the judge may leave if there is nothing else to be done. Further, having the judge present at the first meeting of creditors eliminates the need for the discharge hearing.

C. Valuation of Security.

The valuation of secured collateral requires the court to play a modern Solomon. Generally, the value assigned is that found in the resale market, rather than the replacement value. Where there is not a resale market for the goods, an arbitrary value is selected. While the court is uniquely situated to do this, and can effectively do this in a commercial bankruptcy where there is adequate time to reflect on the worth of particular goods, the volume of consumer cases warrants a different Code approach to valuation of security.

CUNA would suggest that, in valuing goods to be retained or redeemed, courts should give greater weight to replacement value. Consumer goods are bought for personal family or household use and not for resale. Where the consumer is being permitted to retain possession of the goods, the Congress needs to construct a statutory method for placing value on property which balances the resale value of the goods against the replacement cost to the consumer. In constructing such a test, the Congress would eliminate an enormous amount of controversy between creditors and debtors. Again, this would result in a significant speeding of the process and commencement of the debtor's "fresh start."

D. Exemptions.

A major concern is that the "fresh start" intended by the Code has become a "head start." Credit unions throughout the country have found that debtors are aggressively seeking bankruptcy in a number of instances because the extremely liberal exemptions permit them to retain much or all of their personal property while discharging all debts. The concept of bankruptcy is to permit a necessitous debtor to retain the property necessary to begin life after the debts are discharged.

It is obvious that, where the bankruptcy laws encourage debtors who can otherwise repay to seek relief, creditors must change their lending patterns by withdrawing credit or seeking forms of collateral which are not subject to the exemptions. The concern with the federal exemptions has already been demonstrated by the fact that over a third of the states have reimposed state control by adopting more responsible exemptions. This result, which was contrary to predictions that few if any states would not select the federal exemptions, reflects the widespread concern with the federal scheme of exemptions.

CUNA requests that Congress address three specific problems being encountered under the Federal bankruptcy law exemptions. The first would be to eliminate the unused real estate equity exemption for any purpose designated by the debtor. This has resulted in widespread exemption of luxury items and has undermined the general confidence of the public in the fairness of the bankruptcy laws.

The second area would be to put a total dollar limit on the value of items in household furnishings, goods, etc., subject to the current $200 exemption. Placing a cap on this exemption would not represent a return to the days of taking household items as security or deprive debtors of a fresh start through bankruptcy. It would, however, limit the number of possessions retained and would prevent a debtor from converting assets into exempt items such as pieces of silverware.

Finally, CUNA would request that Congress consider not allowing couples who file joint petitions to elect both state and federal exemptions. In a joint case, the ability to select both state and federal exemptions has in some instances made a virtual mockery of the concept of fresh start.

D. Preferences.

Under the Code the trustee has the right to void any payments received 90 days prior to filing of a petition by a consumer/debtor. This includes payments made to the credit union in the ordinary course of a loan repayment. The purpose of the preference law has always been to promote equality among creditors and to deter creditors from applying last minute pressure in the hope of obtaining better treatment than they would in bankruptcy. In the case of a credit union collecting its regular installment payments (for instance, through payroll deduction), the possibility of obtaining the type of preferential payment that the preference provisions of the Code are designed to avoid is minimal. By definition, such ordinary loan payments do not involve any pressure by the credit union which the preference provisions are designed to deter.

Further, the amounts of such payments are so small that the cost of collecting the payments and distributing them among all creditors generally exceeds the amount collected. In fact, credit unions report that the majority of the funds recovered go to the cost of administration rather than redistribution among creditors.

CUNA would support Congressional action to amend the Code to exclude payments received in the ordinary course of an installment debt from the definition of a preference. Where the credit union had no reason to know of the debtor's pending insolvency, exclusion of these payments from the definition of a preference would not undermine the goal of the Code in this area.

E. Discharge Exceptions.

Credit unions have reported relatively widespread use of several technical aspects of the Code that prevent challenge by the credit union of consumer petitions and permit the discharge of debt incurred in anticipation of filing bankruptcy. They have identified three areas in particular. The first involves supplying false or misleading information which is not directly related to the debtor's "financial" condition. Under the present law, a financial statement may be challenged only for those portions of the statement relating to the assets and liabilities of the consumer. Frequently, a credit decision will hinge on the length of time in a residence or on the job. To eliminate this problem, CUNA would suggest that the Code provide that a false credit history be included as a reason for challenging the dischargeability of a consumer's loan.

The second phenomenon, known as "loading up," occurs when a consumer in anticipation of bankruptcy borrows against existing credit lines and then declares bankruptcy. Obviously, many debtors will incur substantial legitimate debts prior to realizing they can no longer repay their obligations. This is particularly likely to happen where extreme medical expenses or loss of job occur. However, to counter the abuse in this area, CUNA would urge the Congress to create a rebuttable presumption that debts incurred in the 90 days prior to filing bankruptcy were indeed nondischargeable. Therefore, if a debtor has a legitimate reason for incurring the debt, it can easily be shown that the debt was incurred to purchase necessary items such as food, clothing, shelter or medical attention. Further, the Congress could adopt a minimum dollar amount of debts below which this presumption would not apply. This would eliminate most challenges of debts being listed at the first meeting of creditors.

The third provision in the Code involves the award of attorney fees to the debtor in any proceeding where the creditor unsuccessfully challenges a discharge unless the court finds that awarding attorney fees would be "clearly inequitable." This standard has had a "chilling effect" on creditor challenges. It presumes that creditors will use their greater economic power to threaten to challenge legitimate debts sought to be discharged in bankruptcy. The mandatory and one-sided nature of this provision goes far beyond what is necessary to protect the debtor from frivolous objections. It injects a standard which is uncertain in the law and which unnecessarily impedes the orderly process of the bankruptcy proceeding. CUNA would suggest the adoption of a good faith standard allowing the court to assess the creditor with the debtor's attorney fees in the event that the action is determined not to have been brought in good faith.

IV. CHAPTER 13--IMPROVING THE PROCESS

A. Best Effort Standard.

Under the Code, Chapter 13 plans must be "in good faith" and must propose to pay the unsecured creditor at least as much as it would receive in straight bankruptcy. Since the Code does not define good faith, debtors have proposed that paying as little as one percent to unsecured creditors satisfies the Code requirements, and some courts have accepted these plans. CUNA urges that Congress re-examine the "good faith" requirement of a Chapter 13 plan and consider including a requirement that a plan must represent the best effort of a debtor. As with a good faith standard in Chapter 7, a court in deciding what constitutes a consumer's best effort will need to examine the complete financial picture of the debtor.

B. Length of Plan.

The present Code provisions call for a Chapter 13 plan to last three years and, with the court's permission, up to five years. This reflects a determination by the Bankruptcy Commission that three years is an adequate time to repay most consumer installment debts. However, in the time between the deliberations by the Bankruptcy Commission and adoption of the Code, dramatic changes took place in the lending patterns *involving* consumer debt. Automobile loans, traditionally 36 months in length, were expanded to 48 and even 60 months in length.

These longer term consumer debt obligations arose out of a willingness by consumers to incur debt over a longer period of time. Given this change in consumer attitudes about consumer debt, CUNA would suggest that the Code be revised to permit as a matter of course repayment over a longer period than three years, e.g., five years. Since consumer debt was originally incurred with the intent of paying it out of future income, this change in the Code would conform more closely to the consumer's expectations in filing a Chapter 13 plan. In essence, the consumer filing a Chapter 13 plan expects to repay all or a portion of debt out of future income. The safety value, of changed circumstances, is always present. Therefore, it is not unreasonable to provide for longer repayment periods in Chapter 13 plans.

The provision of longer period for Chapter 13 plans should not preclude a consumer from offering a repayment plan over a shorter period of time. Where a consumer would agree to pay at least a set percentage of allowed unsecured claims, shorter plans should be permissible. CUNA would suggest a 70 percent minimum payback schedule, because this is the figure chosen for permitting persons who have received a Chapter 13 discharge to file a subsequent Chapter 7 petition within six years. Given the Congressional determination that 70 percent is a substantial commitment to repayment, CUNA would suggest that this figure be incorporated into any minimum standard for debt repayment in less than a five-year.

C. Co-Debtor Automatic Stay.

In consumer bankruptcies, even when creditor rights are not disputed, enforcing those rights can equal or exceed their benefit. In order to enforce a lien against a co-debtor of a consumer who has declared bankruptcy under Chapter 13, a credit union must file a complaint and seek relief from the automatic stay. CUNA would suggest that Congress amend the Code to provide relief from the automatic stay without court intervention in two situations.

The first situation is when the co-debtor receives the benefit of a loan. The second would be relief from the stay when the debtor's plan does not propose to pay the creditor in full. In that situation the credit union should be allowed to proceed directly against the co-debtor without having to file a complaint in court.

D. Commencement of Payments.

A significant problem under Chapter 13 encountered by numerous credit unions has been the lapse of time between confirmation of a plan and commencement of payments. The statute does not provide for the prompt commencement of payments. In order to promote completion of Chapter 13 plans as quickly as possible, payments should begin being made to the trustee as soon as the debtor has filed the plan he believes he can complete. If no plan is confirmed, the payments may be returned after deducting the costs of administration. At least, Congress should consider requiring that the payments begin at the time the plan is confirmed or within 30 days thereafter. The experience of most credit unions is that, where payments begin at the time the plan is filed, there is a much greater incidence of completion of the plan. Where payments are delayed, debtors experience an inflow of income and become accustomed to a level of expenditure that is difficult to reduce.

E. Claims--Classification and Dischargeability.

Credit unions have encountered two discreet problems under Chapter 13 with the classification and dischargeability of claims. The first involves the ability of a debtor to classify unsecured claims in different categories. Frequently this will result in a debtor proposing a plan which calls for classification of one type of loan, e.g., medical expenses, with a much higher repayment schedule for that class than for the other types of unsecured credit. CUNA would, therefore, urge Congress to consider an amendment to the Code which provides only one class of unsecured loans.

The second problem has to do with the dischargeability of claims under a Chapter 13 plan. Under Chapter 7, a number of claims are excluded from discharge. These are, with the exception of alimony and child support claims, all subject to discharge under Chapter 13 plans. Frequently, a debtor with extensive loans secured by false pretenses will propose a Chapter 13 plan providing little or no payment on those claims. The discharge provided is an absolute sham.

CUNA would urge Congress to address this problem immediately. The claims that are nondischargeable in a Chapter 7 proceeding should likewise be nondischargeable in a Chapter 13 proceeding. Allowing a consumer to propose to pay 10 percent on an otherwise nondischargeable claim, and permitting the consumer to get off without further consequence upon completion of 100 percent of the plan, undermines dramatically the integrity of the "fresh start" concept. It also encourages the debtor to propose a low pay-out since discharge is denied if the debtor proposes a plan with a high pay-out level and subsequently cannot complete the plan, unless he or she gets hardship relief.

F. Valuation.

The Chapter 13 valuation process suffers from the same general faults described above in relation to the Chapter 7 valuation proceeding. CUNA would encourage Congress to adopt valuation standards in the statute that help eliminate disputes and speed the process of the bankruptcy proceeding.

CONCLUSION

CUNA appreciates this opportunity to address the important and timely issue of bankruptcy reform before this Subcommittee. We encourage Congress to address these extremely timely issues in this Congress. The burden of the bankruptcies being filed in ever increasing numbers falls not on the bankrupt individual, but on the individual credit union member whose investment in another individual will never be repaid where the Act's relief has been abused.

PREPARED STATEMENT OF RAYMOND W. KLEIN

Thank you for this opportunity to make a statement before the Subcommittee on Courts of the Committee on the Judiciary on the subject of consumer bankruptcy. I am Raymond W. Klein, Vice President, Credit, R.H. Macy & Co., Inc. and I am pleased to appear today on behalf of the National Retail Merchants Association (NRMA) and American Retail Federation (ARF).

By way of background, NRMA is the nation's largest trade association for the general merchandise retail industry. Its corporate members operate 40,000 department, chain and specialty stores across the country, with annual sales of approximately $100 billion, at least half of which are credit sales.

The ARF membership consists of 33 national retail trade associations, 50 state retail associations, the Greater Washington Board of Trade, as well as corporate members. Through its members, ARF represents more than a million retail establishments.

Together, these two associations represent virtually all of this country's leading department stores, mass merchandise stores, and specialty stores. These businesses are vitally concerned with consumer bankruptcy and the need to reexamine several crucial questions relating to the circumstances under which consumers declare bankruptcy.

A great deal of testimony was elicited during the 97th Congress on the subject of consumer bankruptcy. Financial institutions, retailers, academicians and others submitted hundreds of pages of testimony debating the question of whether the Bankruptcy Reform Act of 1978 should be amended in areas such as consumer bankruptcy (S. 2000), as well as commercial bankruptcy issues such as grain elevator and shopping center bankruptcy. Unfortunately, the consumer bankruptcy measure became sidetracked, in spite of the fact that it was co-sponsored by over 280 representatives and 35 senators, when an impasse was reached during the debate over Article III status for bankruptcy judges.

We wish to make it clear at the outset that passage of amendments to the Bankruptcy Code continues to be a high priority for retailing. From 1978 to 1981 consumer bankruptcies increased 165 percent, to 465,914. Although some of this increase can be attributed to high interest rates, inflation and unemployment, part of the increase is due to the fact that debtors can discharge all their debts even though they have the ability to repay a large portion of them. A Purdue University research study estimated that of $6 billion lost in bankruptcies in 1981, over $1 billion could have been repaid by debtors without hardship.

As Sears, Roebuck & Co. testified last year, these losses precipitated a hard look by creditors at the financial circumstances of their customers who filed in bankruptcy. The traditional problems of unemployment, inflation, marital problems, large unexpected expenses, and overspending were found. But, a new and substantial class of debtors - one different from the traditional debtor - was also found. These persons were current on their required monthly payments, had little or no previous history of delinquency, and some even had additional credit available on the account at the time the bankruptcy notice was received by the creditor. Certainly this debtor profile does not fit a creditor's traditional notion of financial distress.

This class of debtors comprises a disturbingly large portion of bankruptcy cases. Data collected by Montgomery Ward indicates that nearly 13% of the accounts taken as a loss due to bankruptcy are up to date at the time the bankruptcy notice is received. Sears, Roebuck and Co. conducted a survey of bankruptcies in 13 states that included over 9,200 cases. That data shows that in excess of 13% of the accounts were current or paid ahead at the time the bankruptcy notice was received. Federated Department Stores conducted a similar study which indicated an increase of over 157% in the number of accounts that were current at the time of bankruptcy from 1979 to 1980.

The losses attributable to bankruptcy which were reviewed during NRMA's testimony delivered before this Subcommittee on April 3, 1981 continue to mount at an alarming pace. Rather than burden this statement with a great deal of data, the following is a small but, we believe, typical sample of bankruptcy losses experienced by retailers.

Federated Department stores experienced losses due to consumer bankruptcy of $2.3 million in 1979, $4.58 million in 1980, $5.34 million in 1981 and the projected figure for fiscal 1982 is $5.63 million.

Dayton Hudson's consolidated figures for consumer bankruptcy losses are $1.7 million in 1979, $3.26 million in 1980, $3.21 million in 1981 and the projected 1982 losses are $5.36 million.

The experience of other retailers is substantially the same. This data should lay to rest the notion that the massive increases in consumer bankruptcy experienced soon after the effective date of the Act were somehow a temporary phenomenon which would correct itself. On the contrary, a very bad situation has continued and is getting worse. Prompt action is necessary to address several problems in this area, some of which I will mention this morning.

Eligibility For Discharge

Our overriding concern, among a number of important issues, is the fact that a large number of debtors are able to have affordable debts discharged in bankruptcy. These are debts which could have been repaid from current earnings after providing necessary support for themselves and their families. The Bankruptcy Code, however, adopts an antiquated assets-based approached to eligibility for relief. This approach fails to reflect the nature of today's consumer credit market, which is largely unsecured (at least insofar as open-end credit is concerned) and is predicated upon the consumer's willingness and ability to repay the debt out of income rather than from proceeds from the sale of assets. The traditional balance sheet analysis of assets versus liabilities that is still prevalent for commercial transactions has given way to a system whereby credit is extended on the basis of capacity to repay, measured by only one asset - earnings potential - coupled with a review of the customer's payment history to gain some measure of willingness to repay.

Unfortunately, revisions to the Bankruptcy Code in 1978 failed to address the assets-based approach to relief. It is essential that an equitable resolution of this problem be made an integral part of any legislative package of consumer bankruptcy amendments.

A two-step approach is recommended to integrate this concept into the Code. First, Section 109 of the Code should be amended to limit the availability of a discharge. Debtors in true financial distress would still be given the complete remedy of discharge. However, debtors able to pay a reasonable portion of their debts from anticipated earnings would be ineligible for Chapter 7 relief.

Second, if a debtor's case is dismissed after a determination that he or she is ineligible for total discharge, this does not mean that the debtor will be left with no relief. Chapter 13 or non-profit Consumer Credit Counseling Services would be available to this debtor.

Turning to Chapter 13, there are wide regional differences in the application of the new law to Chapter 13 cases involving similar factual circumstances. We believe that the reason for this lack of uniformity stems from the absence of meaningful standards in key sections of Chapter 13.

Section 1325 sets forth the standards governing the confirmation of a proposed plan. Section 1325(a)(3) provides that a plan must be proposed in good faith. Section 1325(a)(4) requires that an unsecured creditor receive as much under the proposed plan as if the estate had been liquidated pursuant to Chapter 7. Neither a requirement of "good faith" nor a liquidation equivalency gives the bankruptcy court clear guidelines to use in deciding what is an acceptable payment percentage for unsecured claims in the confirmation of a debtor's plan.

As a result, wide variances exist between the treatment of unsecured claims in plans which have been confirmed across the country. Plans have been confirmed in Seattle requiring a payout of 92 cents on the dollar for unsecured claims while in Denver, in the same time period, plans have been confirmed where the debtor has proposed a payout to unsecured creditors of 1/100 of 1% but not less than one dollar.

The standards of good faith and liquidation equivalency promote lack of uniformity and allow debtors with the ability to repay substantial portions of their debts to avoid repayment.

We recommend amending Section 1325 to provide, in addition to a requirement that the plan be proposed in good faith, a requirement that "the plan represents a bona fide effort which is consistent with a debtor's ability to repay his debts, after providing support for himself and his dependents . . . ."

In connection with the bona fide effort requirement, the debtor's plan must either last for five years or pay a minimum of 70% of the debtor's allowed unsecured claims.

Critics of the proposal to change eligibility standards have argued that the criteria of "reasonable portion of debts" in Chapter 7 and "bona fide effort" in Chapter 13 would provide no more direction for the courts than the current vague standard of good faith. We disagree.

First, these amendments tell the court that it should consider a debtor's ability to pay in shaping appropriate relief. Good faith has been a difficult standard to apply in the Code. This is in part because of the lack of direction given to the court as to the factors it should consider in making a determination that the standard has been met. Our recommendation would give a yardstick by which to make individual measurements--ability to repay debt from anticipated earnings.

Second, the court in a Chapter 13 plan should expect minimum payments of 70% of the debtor's unsecured claims or the best effort the debtor can make over a five-year period, after considering the individual debtor's needs for support of himself and his dependents.

Clearly, the courts will be faced on occasion with difficult decisions. We agree that the recommended change in eligibility standard does not give a black and white, objective rule for easy application in every case. But, we believe that the concept is workable. These amendments, taken as a whole, give the court a solid yet flexible framework in which to operate. the court is given some parameters yet still has considerable discretion.

A Section 1328 hardship discharge would still be available and would act as a safety valve in necessary circumstances.

One criticism leveled at the change in eligibility standard is that it is not necessary; creditors can change their credit procedures and contracts to protect their interests.

We disagree . . . for several reasons. Although over the years retailers have changed their credit granting orientation away from an assets-based analysis to an income-based analysis, account delinquencies have remained at very similar levels. While account delinquencies have been fairly constant, as mentioned earlier, bankruptcy charge-offs have increased tremendously since the enactment of the Code. We believe that our members have maintained a policy of responsible credit extension. If the present bankruptcy charge-off experience continues at these unprecedented levels, some tightening of credit availability is inevitable. This tightening of standards, however, will not protect or prevent charge-offs attributable to a new class of "surprise" debtors. Such debtors declare bankruptcy with no warning or pattern of delinquency prior to filing.

As stated earlier, in a recent sampling of accounts in 13 states, Sears determined that just over 13 percent of its accounts charged-off to bankruptcy had been current or paid ahead at the time of filing. In Philadelphia, 40% of the accounts charged-off to bankruptcy were current or paid at the time of filing. Most of these accounts had little or no previous history of delinquency.

Individuals who declare bankruptcy when their accounts are paid ahead or current present a dual dilemma to the credit manager. These individuals throw a monkey wrench into the customary credit granting analysis. They refute the notion that a customer who consistently pays his or her account according to the terms of the contract has demonstrated the ability to handle credit extension.

Moreover, these individuals, along with those who have only limited levels of overdue payments at the time of filing, suggest to the credit manager that perhaps they are not in the severe kind of financial distress which should call for the drastic remedy of total discharge. Not every financial reversal warrants a discharge in bankruptcy.

Revision of the retailer's credit agreements is also not the answer to this problem. As stated earlier, most retailers' accounts are unsecured. Those retailers who do reserve a purchase money security interest in the goods charged on their accounts do not fare much better. This is because the Code treats a claim as a secured claim only to the extent of the value of the collateral (Section 506). In the context of a security interest in consumer goods, which depreciate rapidly and often have a low resale value, the security interest loses a great deal of its intended protection. Thus, increased use of security interests in the context of the sale of consumer goods is not a viable solution to this problem.

Another objection to changing the eligibility standard is that it contradicts the notion of a "fresh start" by limiting the availability of Chapter 7 discharge. Again, we disagree. it is our opinion that the concept is entirely consistent with historical notions of bankruptcy relief in this country.

We believe that a bankruptcy discharge was intended by its creators to be a remedy of last resort available for debtors finding themselves in irreversible financial distress. Although "entrance requirements" which would limit access to a discharge were not part of the statutory scheme, social values and the limited benefits available under the law caused most debtors to avoid the bankruptcy courts as a matter of self-selection. Debtors rarely sought a discharge unless a true need existed. Over the years, the benefits available in bankruptcy for consumer debtors have increased substantially. At the same time, the social stigma associated with bankruptcy is less intense in today's society.

We do not think it is contradictory to the historical goals behind bankruptcy to legislate a statutory eligibility test for total discharge which replaces an informal process of self-selection, but ensures the availability of relief to the traditional debtor in need.

Some concern has been expressed that these amendments will overcrowd the courts with a flood of litigation. We concede that some increased workload may result for the courts. The increased plan length under Chapter 13 will cause the payments to continue in many cases over a longer period of time. In other plans the individual payments may increase in amount but not necessarily in duration.

There is, however, a counterbalancing benefit to be derived from the reduction in consumer demand for the bankruptcy remedy that is likely to occur as the law is changed to make bankruptcy less desirable for those debtors with minor financial reverses. This reduction in consumer demand may offset some of the increase associated with the increased plan length and additional use of Chapter 13.

For debtors with moderate financial problems, Chapter 13 may not really be necessary. Debtors may be more likely to work out payment plans with individual creditors and avoid the transaction costs involved with bankruptcy such as filing and attorney's fees. Some shift in litigation and workload may occur, but this shift should be of manageable proportions.

Loading Up

The matter of loading up is also of vital importance to the retail industry. One national retailer with stores in 26 states has reported that as much as 35% of the value of its bankruptcy write-off has been attributed to purchases made during the 90-day period prior to filing.

Not infrequently, a debtor will go on a credit buying spree in contemplation of bankruptcy. Typically, the debtor is already insolvent by the time the credit shopping spree begins, and if creditors were aware of the insolvency, they would not extend credit.

A retailing representative testified on this issue on June 15, 1982, during House oversight hearings. We continue to support an amendment to Section 523 of the Bankruptcy Code that would create a rebuttable presumption that any consumer debt incurred by the debtor within 90 days before filing the petition was incurred under circumstances that would make it nondischargeable. The 90-day period is recommended for two reasons. First, present law (§ 547(b)(4)) creates a statutory presumption of insolvency for a 90-day period before the date of filing of the petition. Inasmuch as the presumption of nondischargeability is based in large measure on the presumption of insolvency, both presumptions should span the same period of time.

Second, retailers extending open-end credit have no advance notice of a customer's financial distress and often cannot identify a suspected instance of loading up until 60 days after the purchases occurred. For example, a customer may have been current for several years -- or longer -- and then the customer may purchase five times or more his or her normal amount during the month of July. These purchases will appear on the July 31 bill (received by the customer in early August) on which a payment is due by the August 31 billing date. A retailer will have no knowledge that a load-up had occurred until the August 31 bill is rendered. That can be as long as 61 days after the purchases were made. The retailer would monitor this account carefully after the August 31 billing date. If payment patterns follow purchasing patterns, it is obvious that no loading up has occurred. However, if payments do not follow purchases and loading up is suspected, the retailer will be in a position to restrict further credit authorizations and reduce exposure to potential loss. The retailer is not in a position even to suspect a load-up until after the August 31 billing date; thus, a minimum 90-day period is absolutely essential in order for such a provision to be effective.

It has been stated repeatedly that general merchandise retailers usually do not retain a security interest in their goods. Because of this, our sole remedy when we suspect loading up is to deny further credit. However, we need the 90-day presumption to protect against losses that occur before we have time to react to the shopping spree.

When a debtor is, in fact, insolvent, he or she is strongly tempted to incur debts that are dischargeable in bankruptcy. The provision we recommend would go a long way toward discouraging debtors from running up large balances in contemplation of bankruptcy, but it would still permit customers to demonstrate that debts incurred within the ranges of their customary purchasing patterns should be dischargeable.

Exceptions

The 1978 Bankruptcy Code has substantially increased the amount of property which the debtor can exempt. The Code gives the debtor a choice of electing a set of federal exemptions or those exemptions of the state in which he lives.

The federal exemptions consist of a lengthy list of very generous provisions. For example, each debtor is entitled to a homestead exemption of $7,500 ($15,000 in a joint petition) and personal property exemptions of $1,200 for a motor vehicle, $500 for jewelry, and $200 per item for household goods, wearing apparel, and musical instruments held for personal, family, or household use. This means $200 per saxophone, $200 per knife, $200 per fork, and $200 per spoon. The Act also provides a catch-all federal exemption of $400, and permits the debtor to apply any unused amount of any homestead exemption to any property. An apartment owner, for example, can exempt a mink coat worth $8,100 ($7,500 for the homestead, plus $200 for each item of wearing apparel, plus $400 which may be claimed for any other property).

The Act permits a debtor and spouse to file jointly under Chapter 7 and in many states they can pyramid exemptions by having one elect state exemptions and the other elect federal exemptions. Since some state provisions exempt a set amount of property, whether the exemption is claimed by one debtor or both debtors, the effect of allowing one joint debtor to separately claim the federal exemptions is to give the joint debtors substantial additional exemptions.

These very generous federal exemptions are a prime contributor to the increase in the number of personal bankruptcies. They permit debtors to retain all or virtually all unencumbered personal property, thus providing little or no economic disincentive for filing in bankruptcy.

These exemptions apply in every state, unless a state enacts specific legislation that prohibits a debtor within that state from claiming the federal exemptions. While a substantial number of states have now recognized the excessive coverage of the federal exemptions, and have reinstated revised exemptions in their place, creditors in the remaining states continue to be subjected to the potential for abuse represented by the excesses in the federal exemption laws.

Thus, we urge Congress to revise the structure of federal exemptions in at least three respects. First, prohibit the application of the unused homestead exemption to other property. The public policy justification for this exemption was not to exempt assets, as such, but a particular asset--the debtor's homestead. This was based upon a recognition of the unique importance of the debtor's home in terms of the stability of the family unit. There is no spill-over provision for the other exemptions, such as the $1,200 for a motor vehicle or the $7,500 for personal bodily injury. The homestead exemption should be similarly treated. Second, place a maximum value (we recommend $3,000) on the aggregate amount of exempt household goods, wearing apparel, and musical instruments held for personal, family, or household use. The $200 per item exemption for household and similar goods, with no aggregate limitation, is an invitation to abuse. It permits debtors to exempt an immense number of items, effectively without limit. For example, a 12-place setting of sterling silver worth thousands of dollars can be exempted in its entirety, provided that no single piece is worth more than $200. Clearly, this goes beyond the "fresh start" envisioned by Congress. Third, a debtor and spouse should not be permitted to "double up" their exemptions, using both federal and state exemptions to create a windfall. Joint debtors should be required to elect either state or federal exemptions.

Creditors' Meeting - Discharge Hearing

The matter of the meeting of creditors and the discharge hearing go hand-in-hand. The present provisions prohibit the bankruptcy judge from attending the meeting of creditors, but instead require the judge to preside at a discharge hearing. In effect, this requires a debtor to make at least two appearances and, because the judge is not present to perform vital judicial functions at the meeting of creditors, the debtor quite often will be required to be present for yet additional proceedings. the absence of the judge from the meeting of creditors necessarily forestalls the resolution of many disputes which, if settled, could expedite the bankruptcy process and obviate the need for separate adversary proceedings. For example, threshold matters such as disputes over alleged deficiencies in the debtor's petition and schedules and disagreements over the appropriate scope of inquiry of the debtor must be resolved by a judge. If the judge is available to handle these matters, the remainder of the proceedings typically can be concluded without undue delay and without the need for scheduling separate hearings. Obviously, separate hearings cause procedural delays and result in substantial additional expense, both to the debtor and to creditors.

The discharge hearing as now required simply mandates an additional appearance (and loss of wages) by a debtor to receive information that could be given at the meeting of creditors. In many of the larger districts, such an arrangement actually would better serve the information needs of the debtor than do the currently used mass discharge hearings on a group basis, where there is neither the time nor the opportunity for the type of individual explanation that the drafters of the Bankruptcy Code contemplated.

In short, the meeting of creditors could serve as the forum for the counseling functions at a time when they might have more impact on debtors than at discharge. Use of the meeting of creditors for this purpose would eliminate the need for an additional appearance by the debtor and, conceivably, by creditors. Thus, we recommend that Section 341(c) be amended to require the judge to convene the meeting of creditors and be available to resolve disputes that may arise at that meeting. Since the judge also could counsel debtors at that meeting on the nature and effect of discharge, we also recommend that Section 524(d) be amended to delete the requirement for a discharge hearing.

Reaffirmation

Turning now to the matter of reaffirmation, we believe that the existing provisions of Section 524(c) impose unduly onerous standards on reaffirmation as well as significant procedural obstacles and, therefore, costs to debtors who seek to reaffirm debts. These substantive and procedural obstacles are not only unduly restrictive, they also are unnecessarily paternalistic.

The goal of Congress in restricting reaffirmations was to assure that the debtor did not make a hasty or superficially considered reaffirmation while under the pressures of bankruptcy. We support this objective but it can be accomplished in a manner fully consistent with this goal by amending the Bankruptcy Code to permit reaffirmations without court approval, subject to the debtor's right to rescind any such reaffirmation for a period of 60 days, and, of course, subject to the continuing protection afforded by the automatic stay.

Even with such an amendment, the automatic stay would continue to bar creditors from contacting debtors to seek reaffirmations. Current practice would be continued; reaffirmations would be initiated by the debtor or arranged through counsel.

Many debtors have important reasons for wanting to reaffirm a debt. In the retail industry, debtors want to reaffirm in order to reestablish a much needed credit relationship with the merchant. In other cases, the debt sought to be reaffirmed may have been cosigned by a friend or relative, or the reaffirmation may involve redemption of much needed collateral. Indeed, whatever the reason, the debtor should have the unfettered right to reaffirm, subject to the protection afforded by the automatic stay and by a concomitant right for 60 days to rescind the reaffirmation.

In closing, there are a number of problems which we believe merit legislative attention in addition to those mentioned today. These include the issue of valuation and the voidable preference provisions, among others. We feel that they all should be treated together because they are interrelated parts of the whole package of rights and duties in the field of consumer bankruptcy.

I thank you for this opportunity to express the views of retailing on this important subject. I will be glad to try to respond to any questions that the Subcommittee may have, and if I am not able to supply the answers today, they will be furnished to the Subcommittee for the record in the near future.

Senator DOLE. Our next witness is Prof. Lawrence King, followed by a panel.

STATEMENT BY LAWRENCE P. KING ON BEHALF OF THE NATIONAL BANKRUPTCY CONFERENCE

Senator DOLE. Professor King, your entire statement will be made part of the record, and it would be helpful if you could summarize what you have to say.

Mr. KING. Thank you, Mr. Chairman. I will be brief.

There are three general observations I would like to make as a result of listening to the testimony this morning.

BANKRUPTCY COURT

The first is that it seems essential to us that the court problem be faced up to and solved in advance of anything else, and in reading and applying the *Marathon* decision, the only way to do that, the only real alternative, is by means of an article III court.

The compromises that have been spoken of today and before really do not play a part at this time because those compromises really were made back in 1977 and 1978. It is now that the Supreme Court has spoken and has said that those compromises would not work as a constitutional matter, and, therefore, the only solution, if there is to be an efficient system at all in the bankruptcy area, is an article III court. That is No. 1.

No. 2, I was surprised, and I must say very much disappointed to hear Mr. Rose say this morning that he supported the proposal of the Judicial Conference. It seems very inconsistent to me that the Department of Justice could take the position that the emergency rule as now in effect is invalid and at the same time say that this proposal of the Judicial Conference would be valid, because all it does is to again bifurcate, you might even say trifurcate, jurisdiction in bankruptcy matters.

In terms of efficiency, let me just point out that what would happen is that a matter of administration would first go to the so-called bankruptcy administrator. The bankruptcy administrator would decide it, and do not be fooled by labels, because that would be a final judgment, if nobody objected, or appealed to the district court. That is the way the proposal is drafted. The Supreme Court said that is no good because this person is not an article III judge.

The matter could then go to the district court. The district court at that point does not have to rule on it, because the district court can then send it to the magistrate. The magistrate can decide it and that, too, would be a final judgment if the parties so consented. I suggest to you that there may be a constitutional infirmity in that respect.

I did not know the Judicial Conference's proposal was going to be brought up today, but with the chairman's permission, I would like to add a supplemental written statement to the record entitled "Addendum to National Bankruptcy Conference Statement in Opposition to Proposed Judicial Conference Rule."

Senator DOLE. That will be made part of the record.

Senator HEFLIN. Do you have copies of that?

Mr. KING. I just have one copy.

Senator DOLE. We can make copies.

Mr. KING. The proposal is that the court problem be separated from everything else. The Supreme Court has told us we have a problem, and it seems necessary to me to solve that problem.

CONSUMER DEBTOR AMENDMENTS

With respect to the substantive law amendments, however, I would like to say that not only is the threshold test proposed by the consumer credit industry improper for our system, and should not be adopted, but just about all the suggestions in S. 2000 in the previous Congress would do an injustice to our bankruptcy system, and I say that for one basic reason.

That, too, really represents matters that were compromised, that were studied in years past. Senator Dole, when you opened these hearings this morning, you mentioned that it may well be necessary to affect compromises or get back to the delicate balance between debtors and creditors in the consumer area.

I suggest to you, sir, that that is what was done in the 1978 Bankruptcy Code. Prior to that time, under the Bankruptcy Act of 1898, there were many consumer creditor abuses that developed in the bankruptcy system, rendering the discharge in bankruptcy essentially ineffective. That is through the use of collateral, consumer collateral, household furnishings having no value whatsoever. That was through the use of reaffirmation of debts, over which there was no restriction whatsoever under the former Bankruptcy Act.

Just about every single one of those changes contained in the Bankruptcy Reform Act of 1978 was to get back to, and to create a balance between, debtors and creditors in the consumer area, and I would suggest that if there was a reversion, if the amendments proposed by S. 2000 were to be adopted by this Congress, the next step would be a re-creation of those very same abuses.

My understanding, as a matter of fact—and I do not have this document in front of me, but it was mentioned by Judge Merrick this morning—is that some of them are already coming back in our bankruptcy system even without those amendments.

I see my time is up. I will complete my summary at this point and answer whatever questions I can.

Senator DOLE. Senator Heflin?

Senator HEFLIN. Do you have any thoughts on the Johns-Manville case, how do you solve this problem?

Mr. KING. Yes. I would offer two responses to it. How would I solve it? That is a tough one.

Senator HEFLIN. How would you approach it?

Mr. KING. There is a correct and proper analysis of the time itself.

There is one thing that we ought to bear in mind on anything having to do with the Bankruptcy Code. A lot of it is not new. A lot of it has nothing to do with the Bankruptcy Reform Act.

I think this is one example. Senator Heflin, I would suggest that the Johns-Manville case could have been filed under the former Bankruptcy Act, under chapter 10 of the former Bankruptcy Act, as a corporate reorganization case.

I suggest that would have been possible. I am not saying that it would have been done. I am only saying that it could have been done.

Could the court, the chapter 10 court take over a lot of the litigation you are worried about if a chapter 10 case had been filed? The answer would be yes, because those claimants, those plaintiffs, could have been required to file their proofs of claims in the chapter 10 court.

Could that have been before the bankruptcy judge instead of the Federal district judge? Yes; because in most jurisdictions chapter 10 cases were referred from the district judges to the bankruptcy judges. That is directly contrary to what Judge Williams was saying this morning of the willingness of district judges to handle bankruptcy matters. They do not want to handle bankruptcy matters, pure and simple.

The second point concerning Johns-Manville: With respect to the jurisdiction issue, which I recognize is a major issue, and I would hope the bankruptcy judges would handle that issue properly, and I can respond to that in a moment, but it is tangential.

With respect to your main question, though, about using the Bankruptcy Code for the Manville-type case, I am not sure that case can be successful under the present wording of our Bankruptcy Code.

This has not been done before. There are consequences, there are rulings, which the chapter 11 debtor will need from the highest court, not from the bankruptcy court. Nothing is going to stop at that level.

There are rulings that will come out of that case that will have to go to the Supreme Court of the United States and it is after those rulings that one will learn whether this case can be successful.

The point is, it seems to me, in that type of a product liability case, in order for it to be successful, that is, in order not to have the company liquidated but have it reorganize and continue to function as a company, it has to make provision for unknown claims, persons who have not yet been injured or who may be injured, or whose injury may be manifested sometime in the future.

This is a major problem under the wording of the Bankruptcy Code. It is questionable whether that is possible or not. My answer to you would be that it might well be appropriate for the courts themselves to fashion that result, have counsel present briefs, and have the courts determine whether that can be done or cannot be done.

As I mentioned, though, this is something that would be done by the highest level court. It would start in the bankruptcy court, but it would go all the way up.

Senator HEFLIN. Do you foresee a problem in the case, *ERA* v. *Thompson,* I believe it is, in the asbestos cases, that some States have certifications from the various types of circuit courts of appeal back to the State supreme court to certify questions. But the different forum bringing together all one type of litigant in one case being allowed damages and another not being allowed damages, if you continue with this, is there any solution to this problem?

Mr. KING. The code itself was not drafted with this type of a case in mind, and I think, also, it is not necessarily the conclusion that all of these cases can be brought into the one forum.

Under the present wording of the code, if we forget about the *Marathon* case, and let's assume that case did not come up, what would happen?

Let us take a number of plaintiffs' actions, say, in Alabama, a number in California, a number in Texas, all over the country. They do not automatically get to the bankruptcy court in New York. Under the removal provision of the Bankruptcy Reform Act, what would happen, if the debtor were so inclined, is that the actions would be removed not to the bankruptcy court in New York where the chapter 11 case is pending, but to the bankruptcy court sitting in Alabama, the bankruptcy court sitting in Los Angeles or Dallas, wherever that particular action or those actions themselves are pending.

There would be two steps, or alternative steps that could be taken in the Alabama, New York, or Los Angeles bankruptcy court.

The bankruptcy judge could remand, and say, "This has no business being in bankruptcy court. All we need to know in the bankruptcy court in New York is the amount, what amount is this debtor indebted to the plaintiff. We do not care about the liability. If you care about the liability, we can remand the case, and that is not an appealable order."

There are actually three alternatives. The second would be to retain the case. Now, if there are 1,000 cases pending in Alabama, frankly, I do not see the bankruptcy judge retaining the case. I think the bankruptcy judge has a lot of other things to do.

Third, as an alternative, the bankruptcy judge would call on another motion by a party in interest to transfer those cases to the bankruptcy judge sitting in New York, that is, handling the chapter 11 case, and, frankly, I could not see that happening because that judge would be then inundated by cases that could conceivably come from all parts of the country.

The point I am trying to make is that it is not a necessary conclusion that all these cases are going to be decided in that one forum. They could well be decided in the places where they started.

Senator HEFLIN. Let us apply to the Johns-Manville situation future ability to pay.

Now, if we go on to S. 2000 and we go with the concept that relief, and in effect, would this mean that perhaps the bankruptcy courts might well keep a Johns-Manville within their jurisdiction for 30, 20, or 10 years?

Mr. KING. I would say that I do not think that S. 2000 has anything to do with it. S. 2000, and this is one of the criticisms as a matter of fact of the whole threshold test, applies only to individuals and discriminates against individuals; it permits corporations and partnerships to go into chapter 7 without any requirements or threshold test and get a discharge.

As far as Manville is concerned, though, I think that there is a chance that it can stay in the bankruptcy court for a good many years, depending on how they elect and how the courts permit them to elect to treat these future claims which people do not presently know they have against the company.

Whether that is permissible or not under the present Bankruptcy Code is not a resolved issue. That is an open issue.

Senator HEFLIN. Thank you.

Senator DOLE. Professor King, just so the record could be clear, so everybody will know when they read the record, can you describe the organization of the National Bankruptcy Conference? We know the credit people are here representing that group. What is the National Bankruptcy Conference?

Mr. KING. The National Bankruptcy Conference is a private organization; not government, public, or anything else. It is just a voluntary organization composed of three groups of people. They are lawyers who practice in the bankruptcy area, both reorganization- and liquidation-type cases, business and consumer cases.

It does have membership from the bankruptcy judges. There are bankruptcy judge members, there are a couple of district court judges who are members, and the third category is made up of law professors from around the country who specialize or teach in the bankruptcy area.

The National Bankruptcy Conference was formed back in the mid-thirties to assist the Congress in drafting and adopting the 1938 Chandler Act amendments to the Bankruptcy Act. The organization has remained in existence since that time, and its sole purpose is to seek the improvement of the bankruptcy law and practice. There is no one group which it represents. It doesn't represent just secured creditors, or unsecured creditors, shareholders or debtors, just the general range. I was not in it in 1937.

Senator DOLE. Well, I appreciate that very much.

Senator HEFLIN. Do you have a legislative coordinator?

Mr. KING. I meant to say at the outset I appear by myself without a lobbyist or a national coordinator. We have none. We probably could use one.

Senator DOLE. There are a lot of them around.

Mr. KING. We cannot afford one.

Senator DOLE. A lot of them are uncoordinated.

Mr. KING. Being a voluntary organization, we have no budget.

Senator DOLE. Thank you, Professor King. We appreciate your excellent statement. I hope we can resolve the issues you addressed. You suggest no change at all. Perhaps there should be some compromise, if that is not an overused word around here.

Thank you.

Mr. KING. Thank you.

Senator HEFLIN. Maybe we had better give a new term to compromise, and call it coordination.

[The prepared statement of Mr. King and statement of the National Bankruptcy Conference, with addendum, follow:]

National Bankruptcy Conference
(A voluntary organization composed of persons interested in the improvement of the Bankruptcy Act and its administration.)

STATEMENT OF

LAWRENCE P. KING

My name is Lawrence P. King. I am the Charles Seligson Professor of Law at New York University School of Law, counsel to the New York City law firm of Wachtell, Lipton, Rosen & Katz and Editor-in-Chief of the multi-volume treatise, Collier on Bankruptcy. I have been teaching bankruptcy and related commercial law courses at New York University School of Law for more than 20 years and I have lectured extensively throughout the country on the subject of bankruptcy.

In addition to appearing on my own behalf, I am appearing on behalf of the National Bankruptcy Conference which is a voluntary, nonprofit organization composed of lawyers, judges and professors with expertise in the field of bankruptcy law; the sole function of the Conference is to assist Congress in the improvement of the bankruptcy law and practice, a function it has been performing since about 1937.

I understand that the current hearings of the Subcommittee are considering all aspects of proposed changes to the 1978 Bankruptcy Code. I have been asked to comment on the changes affecting individual or consumer debtors, that is, the proposals for amendment to the Code recommended by the consumer credit industry. There are basically two conclusions I reach with respect to these amendments which I urge upon this Subcommittee, the Judiciary Committee and the Senate: procedurally, the amendments should not be considered now; and, on the merits the amendments should not be approved because they are unsound.

As to the first point, the Congress should only be concerned with alleviating the bankruptcy court crisis which the Senate helped create in 1978 and resulted in the June 28, 1982 decision of the Supreme Court in Northern Pipeline Constr. Co. v. Marathon Pipe Line Co., 102 S.Ct. 2858 (1982). We are all aware of the fact that the Supreme Court held that the portion of the Bankruptcy Reform Act of 1978 that granted pervasive jurisdiction to the bankruptcy courts was unconstitutional because such courts were Article I and not Article III courts under the Constitution. We are also all aware of the fact that the Court's decision became effective, after the expiration of two stays and the absence of Congressional action, on December 25, 1982. Finally, we are aware of the fact that district courts have adopted as a local rule, a rule drafted under the aegis of the Judicial Conference of the United States.

The local rules so adopted are patently invalid as a legal matter because the district courts have neither the jurisdiction nor the authority to adopt such a rule or to handle any bankruptcy matters. And, as a result of the Supreme Court's decision, the bankruptcy courts have no jurisdiction and none can be granted them validly, by means of a local rule of court. The reasoning for these conclusions is contained in a memorandum entitled Statement of the National Bankruptcy Conference in Opposition to Proposed Judicial Conference Rule which I attach hereto and which is also printed in the Congressional Record of December 13, 1982 at pages H9640 - H9643.

As a result of the above listed events and nonevents, the major problem and crisis situation facing Congress is the court situation. Congress should now devote its energies exclusively to enacting corrective legislation to cure the defects in the bankruptcy judicial system found to exist by the Supreme Court. This is essential to permit the ongoing reorganization of businesses and relief required by financially distressed individuals. All else pales into insignificance.

At hearings before the Senate Judiciary Committee in July of 1982, witnesses including myself urged the Committee to focus exclusively on the court structure problem and not to hold resolution of it hostage to private interest legislation. Those urgings went unheeded and as a result no legislation was forthcoming either during the summer months or during the lame duck session of the 97th Congress. It is even more urgent that this approach be taken by the Congress now because the stay of the Supreme Court's judgment no longer is in effect.

Accordingly, I reiterate and urge upon the Chairman to treat the court problem solely, without reference to amendatory legislation to the substantive law provisions of the Bankruptcy Code. I further urge and emphasize the need for the Congress to enact legislation establishing the bankruptcy courts as Article III courts in order for the courts to exercise the jurisdiction necessary for the proper and efficient administration of the bankruptcy laws of the United States.

In terms of the merits of the proposals contained in what was S. 2000 in the 97th Congress, I recommend as strongly as I can that they not be passed by the Congress. They do not improve the system, they will work a hardship on individuals who are already in a great deal of difficulty, and they will be a move in a backward direction, permitting the reinstitution of abuses that existed under the Bankruptcy Act of 1898.

The so-called threshold test has nothing to recommend it. It has never been a part of the system or tradition in the United States and while perhaps not technically violative of the 13th Amendment to the Constitution comes very close to it in word and in spirit. This test would not permit an individual overburdened with debt, to use chapter 7 (the liquidation provisions of the Bankruptcy Code), and obtain a discharge from debts. It would force such an individual to commence a case under chapter 13 and propose a plan for the repayment of debts over a five year period. Yet, a business debtor, whether a partnership or a corporation, could use chapter 7 on a purely voluntary basis. Why add such a requirement for individuals?

The consumer finance industry would like to have mandatory chapter 13 in the bankruptcy laws. It has been attempting to add such a requirement since at least 1965 but it has been unsuccessful, fortunately. It should not have any better success now. In order for chapter 13 to work properly, individuals must use it of their own volition. One may be encouraged to use chapter 13, there may be incentives supplied for its use, but once it becomes mandatory or required on an involuntary basis, it will lose its utility altogether. One cannot be forced to stay in a job merely to comply with a plan or arrangement, particularly over a five year period. In essence, any threshold test would be counter-productive.

If the consumer finance industry were really concerned about improving the system and if Congress were really concerned with reducing the number of individual bankruptcy filings, both would do something about the very causes of such increase. Lower unemployment, lower interest rates, focus on improving the economy, and the results will include a reduction in the number of people making use of the Bankruptcy Code.

One concept that permeated the study and report of the Commission on the Bankruptcy Laws of the United States in 1970-1973 which led to the Bankruptcy Reform Act of 1978 was the need to adopt a realistic approach to the competing tensions existing between lenders and consumer borrowers. This was articulated in provisions dealing with exemptions, § 522, redemption of property from liens, § 722, restrictions on the reaffirmation of debts, § 524, and the stay of actions against codebtors, § 1301. Each of the changes contained in these sections was meant to make the bankruptcy process more effective and meaningful. Under the Bankruptcy Act of 1898, through liens on personal property such as household furniture, consumer finance companies were able to persuade the unknowing and unrepresented bankrupt to sign an agreement reaffirming the discharged debt, which agreement was held enforceable under state law. The Bankruptcy Code of 1978 recognizes that the lien on the furniture is virtually worthless and is not relied on by the lender and, pursuant to § 522, it therefore may be declared void at the instance of the chapter 7 debtor. This does not in any way change the expectations of the parties.

The codebtor stay gives the chapter 13 debtor a little more breathing room. For a limited period of time it relieves that debtor from familial pressure to pay a debt on which the relative is obligated as guarantor. The provision in § 1301 does not in any way relieve such guarantor of liability; it merely suspends the day of reckoning until it can be determined what portion of the debt will be paid by the principal debtor under the chapter 13 plan.

In all of these areas the consumer finance industry wishes to revert to the former practice so that it can have greater flexibility in arm twisting and highly pressurized tactics. S. 2000 would reinstate the validity of the liens mentioned above, the net effect of which would be to give the lenders greater leverage to obtain reaffirmation agreements. And it should be remembered that the more the reaffirmation is used and made enforceable, the less effect is given to the Congressional intent to permit debt ridden consumers to obtain a fresh start, or a new financial life. So long as we retain our tradition of permitting one to obtain a discharge, we should be careful to leave the discharge unrestricted so that it will serve the purpose for which it is intended.

The industry has already been extremely successful in pulling the teeth of the exemption section. Through its efforts on a nationwide basis, it has induced over three-fourths of the state legislatures to enact legislation prohibiting its domiciliaries from using the federal list of exemptions contained in § 522. Such state prohibition is recognized by § 522 and it is interesting to note that it did not take long for the federal list to be eliminated. It is also interesting to note that the filings in those states have not decreased since enactment of the so-called "opt out" legislation.

In all, I suggest to this Subcommittee that the 98th Congress' counterpart to S. 2000 is not worthy of enactment and would prove a disservice to those in need of financial relief. I recommend that it not be adopted. Certainly, it should not be considered until the Congress has resolved the court problem.

STATEMENT OF NATIONAL BANKRUPTCY CONFERENCE IN OPPOSITION TO PROPOSED JUDICIAL CONFERENCE RULE

On September 28, 1982, the Judicial Conference of the United States submitted to each federal circuit a rule proposed for adoption by the federal district courts, prompted by the decision of the Supreme Court in Northern Pipeline Construction Co. v. Marathon Pipe Line Co., 102 Sup.Ct. 2858 (1982), that, effective October 4, 1982 [later extended to December 24, 1982 (103 Sup.Ct. 199 (1982))], the bankruptcy courts would lose all jurisdiction in bankruptcy cases. The rule was proposed for adoption "in the absence of Congressional action or extension of the stay" to "permit the bankruptcy system to continue without disruption in reliance upon jurisdictional grants remaining in the law as limited by" Marathon. Since this proposed rule is regarded in some quarters as a complete, or at least a workable, solution to the chaos that would otherwise result if Congress fails to act before the bankruptcy courts lose all jurisdiction, the National Bankruptcy Conference considers it imperative that it record its views that the proposed rule (1) is invalid, or of such dubious validity that the additional litigation it will provoke will bring about the same chaos it is supposed to avoid, and (2) in any event is wholly unworkable.

THE PROBLEM

Under the old Bankruptcy Act, "courts of bankruptcy," consisting of the federal district courts and the referees appointed by them for six-year terms with salaries subject to diminution (by Bankruptcy Rule 901(7), effective in 1973, the referees were redesignated "bankruptcy judges"), were given "original jurisdiction" over the bankruptcy case proper, including such matters as rulings on petitions, allowance of claims, rulings on discharge, and confirmation of plans. (Bankruptcy Act, §§ 1(1) and (26), 2a, 34, 38, and 40.) Their jurisdiction in this area was exclusive. 1 Collier, Bankruptcy, ¶2.06 (14th ed., 1968). This was recognized by § 23, par. 19, and § 256, par. 6, of the Judicial Code of 1911 (36 Stat. 1087), later codified in a single section but unchanged as to substance in the Judicial Code of 1948 as 28 U.S.C. § 1334: "The district courts shall have original jurisdiction, exclusive of the courts of the States, of all matters and proceedings in bankruptcy."

Under § 23 of the old Bankruptcy Act, the courts of bankruptcy also had jurisdiction over "controversies" arising in the bankruptcy case about property in the custody of the court (defined as property that was, on the filing of the petition, in the custody or control of the debtor, or of one not holding under an adverse claim of right, or of one holding under an adverse claim that was "merely colorable"). In addition, their jurisdiction extended to other "controversies" with the consent of the defendant. This jurisdiction was not exclusive, but concurrent with that of any other court which would have had jurisdiction of the controversy in the absence of bankruptcy. Collier, supra. In addition, special provisions in old §§ 60b, 67e, and 70e(3) provided that, quite apart from custody of property or the consent of the defendant, the courts of bankruptcy and "any State court which would have had jurisdiction if bankruptcy had not intervened" should have concurrent jurisdiction of controversies under those sections.

This bifurcated·jurisdiction in the second class of matters, i.e., over "controversies," turning largely on questions of the "colorability" of adverse claims or the "consent" of the defendant, tended to produce more litigation about jurisdiction than about the merits of the controversies and meant, if the trustee or debtor in possession lost the jurisdictional dispute, that he must go and litigate the merits in courts that might be quite distant from the court entertaining the bankruptcy case, at great loss of time and expense. Frequently, it seemed the better part of wisdom either to bring the action in such other court originally, or to abandon it.

This feature of the old Bankruptcy Act was widely recognized as one of its most serious defects, and the Commission on Bankruptcy Laws of the United States (which included representatives of the Judicial Conference), the American Bankers' Association, the National Commercial Finance Conference, the National Bankruptcy Conference, the Commercial Law League of America, the Department of Justice, and the Judicial Conference, all recommended a unified bankruptcy court jurisdiction.

Perhaps the greatest advance in the expeditious and economical administration of bankruptcy cases was new 28 U.S.C. § 1471 which, in its first three lettered subsections:

> (a) Gave the federal district courts "original and exclusive jurisdiction over all cases under title 11."
>
> (b) Gave the district courts "original but not exclusive jurisdiction of all civil proceedings arising under title 11 or arising in or related to cases under title 11" -- without regard to custody of property or consent of the defendant.
>
> (c) Provided that the newly constituted bankruptcy courts "shall exercise all of the jurisdiction conferred by this section on the district courts."

As the new Bankruptcy Code originally passed the House, the newly-constituted bankruptcy courts were to be staffed by Article III judges. Due largely to the efforts of the Judicial Conference, that proposal was defeated in the Senate. Under new 28 U.S.C. §§ 151-154 as enacted, the new "bankruptcy courts" are created as "adjuncts" to the district courts, to be staffed by bankruptcy judges, to be appointed after April 1, 1984, who are to be Article I judges appointed for 14-year terms, and whose salary is subject to diminution. Until these judges are appointed, § 404(a) of Public Law 95-598 provides that "courts of bankruptcy," as defined in § 1(10) of the old Act and created by § 2a of the old Act, shall continue to function. And § 405(a) and (b) of P.L. 95-598 provide that they shall exercise the jurisdiction conferred by § 241 of P.L. 95-598, which enacts new 28 U.S.C. § 1471.

The Marathon decision of last June, which invalidated the jurisdictional grant of § 1471, was a case involving a breach of contract action, governed entirely by state law, brought by a Chapter 11 debtor in possession against a third party in the bankruptcy court pursuant of 28 U.S.C. § 1471(b) and (c). A majority of the Supreme Court, made up of a plurality of four Justices and a concurrence of two more, held the jurisdictional grant to bankruptcy courts under 28 U.S.C. § 1471 to be in part unconstitutional, because the bankruptcy judges were not Article III judges, and further held that the balance of the jurisdictional grant to these courts was nonseverable and invalid for that reason, but stayed its judgment until October 4, 1982. On October 4, it further stayed its judgment to and including December 24, 1982.

Just how much of the jurisdictional grant of 28 U.S.C. § 1471 is unconstitutional is unclear. Arguably, § 1471(a), giving the federal district courts original and exclusive jurisdiction of the bankruptcy case proper, and so much of § 1471(c) as directs the bankruptcy courts to exercise that original and exclusive jurisdiction, was not involved in the constitutional ruling. And the two concurring justices, one of whose votes was necessary for a majority, would have confined the constitutional ruling to the case before it, which implicated only so much of § 1471(b) as gave the district courts original but not exclusive jurisdiction of the debtor in possession's action to enforce the state law cause of action as one "related to" the Chapter 11 case, and so much of § 1471(c) as directed the Chapter 11 court to exercise that jurisdiction (192 Sup.Ct. at 2882). But the plurality opinion, while stating that "at the least, the new bankruptcy judges cannot constitutionally be vested with jurisdiction to decide this state-law contract claim" (102 Sup.Ct. at 2880, fn. 40), goes on to indicate that the constitutional objection extends to efforts to authorize Article I courts to decide disputes over "private rights" (102 Sup.Ct. at 2870-2871) or "rights created by state law" (102 Sup.Ct. at 2878) (which raises some doubt about even the constitutional authority of the bankruptcy courts to allow claims based on state law, as most claims are, under § 1471(a) and (c)). The plurality also indicates that constitutional objections may not extend to efforts to authorize Article I courts to enforce "Congressionally created rights" or "public rights" (102 Sup.Ct. at 2869-2870), at least where the final determination is left to an Article III reviewing judge (102 Sup.Ct. at 2875-2879) (which raises some doubt about the constitutional validity of § 1471(b) and (c) insofar as they would authorize bankruptcy courts to resolve disputes which do involve an interpretation of substantive provisions of the Bankruptcy Code such as the avoidance of preferences under § 547 or the denial of discharges under § 727, even though the plurality also suggests (102 Sup.Ct. at 2871) that "the restructuring of debtor-creditor relations, which is at the core of the federal bankruptcy power," may involve "public" rather than "private" rights).

In any event, since six justices are agreed (102 Sup.Ct. at

2880, fn.40, and 2882) that what is not unconstitutional in § 1471's grant of jurisdiction to bankruptcy courts is nonseverable and invalid for that reason, it is clear that the bankruptcy courts will lose all jurisdiction after December 24, 1982, unless Congress acts or the Court again extends the stay of its judgment. The proposed Judicial Conference rule is supposed to bridge the gap in the event that neither the Court nor the Congress acts by that time. For the reasons indicated below, the National Bankruptcy Conference is of the view that the proposed rule is both invalid and unworkable.

INVALIDITY

1. The assumption that the bankruptcy jurisdiction which the bankruptcy courts lose will vest in the district courts.

This assumption underlies the entire proposed rule and a September 27, 1982, memorandum of the Administrative Office of the United States Courts that accompanies the submission of the proposed rule states:

> Marathon does not cause a jurisdictional lapse. The Administrative Office concludes that Marathon did not invalidate 11 [sic] U.S.C. sections 1471(a), (b). In addition, sections 404 and 405 of the 1978 Act also vest bankruptcy powers in the district courts as "courts of bankruptcy" until 1984.

A. 28 U.S.C. § 1471

Presumably, the Administrative Office memo is intended to say that Marathon invalidated only § 1471(c), directing the bankruptcy courts to exercise all of the jurisdiction conferred by § 1471(a) and (b). But § 1471(c) is merely another way of saying two things: (1) the bankruptcy courts shall exercise all of the jurisdiction and (2) the district courts shall exercise none of it. A decision that the jurisdictional grant to the bankruptcy courts is invalid is not a decision that the prohibition of the exercise of any of that jurisdiction by the district courts is likewise invalid. Indeed, footnote 40 of the plurality opinion (102 Sup.Ct. at 2880), with which the concurring opinion agreed (102 Sup.Ct. at 2882), in explaining its nonseverability ruling expressly declined to go that far:

> . . . . Nor can we assume, as The Chief Justice suggests [dissenting opinion, 102 Sup.Ct. at 2882], that Congress' choice would be to have this case "routed to the United States district court of which

> the bankruptcy court is an adjunct." We think that it is for Congress to determine the proper manner of restructuring the Bankruptcy Act of 1978 to conform to the requirements of Art. III, in the way that will best effectuate the legislative purpose.

What a majority of the Supreme Court left to Congress to do cannot be done by a dissenting opinion, the Administrative Office, the Judicial Conference, or a district court rule.

B. Sections 404 and 405 of P.L. 95-598

The alternative assertion in the Administrative Office memerandum, that §§ 404 and 405 of P.L. 95-598 "vest bankruptcy powers in the district courts as 'courts of bankruptcy' until 1984" perpetuates a view expressed in a July 22, 1982, memorandum of the Administrative Office's General Counsel which is printed in House Report No. 97-807 at p.30. As has been amply demonstrated (see House Report No. 97-807 at pp.32-49), that memorandum misconstrues §§ 404 and 405 of P.L. 95-598 as "incorporating and preserving" the jurisdiction conferred on the old courts of bankruptcy by § 2a of the old Act. But all these sections really do is to direct that the courts of bankruptcy as defined in old § 1(1) and created by old § 2a shall exercise the new jurisdiction (now known to be invalid) defined in 28 U.S.C. § 1471 as enacted by § 241 of P.L. 95-598. That memorandum also ignores § 401(a) of P.L. 95-598, which repeals the old Act in its entirety, including the jurisdictional grant in old § 2a, effective October 1, 1979.

The National Bankruptcy Conference believes that the memorandum's reading of P.L. 95-598, which would revert to the bifurcated jurisdictional grants of the now-repealed old Bankruptcy Act, is clearly wrong, and thus provides no support for the Judicial Conference's rule. But, even if it were correct on this point, it would invoke jurisdictional grants which, as footnote 31 to the plurality opinion in Marathon reminds us (102 Sup.Ct. at 2876), have never been "explicitly endorsed" by the Supreme Court but which seem in considerable jeopardy also in view of the Marathon ruling.

C. 28 U.S.C. § 1334

The Judicial Conference apparently does not invoke, although others have invoked, as a basis for finding bankruptcy jurisdiction in the district courts, old 28 U.S.C. § 1334, giving the district courts original jurisdiction, exclusive of the courts of the States, of "all matters and proceedings in bankruptcy." While that section is to be replaced by a new 28 U.S.C. § 1334 dealing solely with the appellate jurisdiction of district courts over bankruptcy courts, the replacement under § 402(b) of P.L. 95-598 is not to take effect until April 1, 1984. The failure to repeal old § 1334 sooner is quite probably an inadvertence since it adds nothing to new § 1471(a). In any event, if old § 1334 is given continuing effect, it arguably gives the district courts only a limited original and exclusive jurisdiction over the bankruptcy case proper and not the pervasive, concurrent jurisdiction that the Judicial Conference's proposed rule assumes the district courts have over controversies arising under or related to cases under title 11.

D. 28 U.S.C. § 1331

Some have also argued, although the Judicial Conference apparently does not so assume, that district courts have bankruptcy jurisdiction as part of their federal question jurisdiction, which is defined today in 28 U.S.C. § 1331 to include all civil actions "arising under the . . . laws . . . of the United states." It has been defined in the same way since 1875 (18 Stat. 470), save that there was originally a requirement that the amount in controversy exceed $500, a requirement that was increased over the years until in reached $10,000 in 1958 (72 Stat. 415) but was eliminated entirely in 1980 (94 Stat. 2369). Passing the points that the federal question jurisdiction has never been viewed as including bankruptcy jurisdiction, that it would have been inadequate to do so at any time until elimination of the amount in controversy requirement in 1980, and that, since 1841, every time Congress has enacted a bankruptcy law it has not relied on the federal question jurisdiction but has enacted a separate provision conferring the bankruptcy jurisdiction on the bankruptcy courts (5 Stat. 446; 14 Stat. 517; 30 Stat. 545, 552; 92 Stat. 2668), it is obvious that the federal question jurisdiction is not adequate to enable the district courts to deal with bankruptcy cases. The proposed Judicial Conference rule assumes that all matters "related to cases under title 11," although they involve no federal question whatsoever, are now within the jurisdiction of the district court. *Williams* v. *Austrian*, 331 U.S. 642 (1947), holds that the jurisdictional grant in § 2a of the former Bankruptcy Act to district courts to cause the estates of bankrupts to be collected gave them pendent jurisdiction, regardless of diversity of citizenship or the presence of a federal question, to entertain a Chapter X trustee's action against officers and directors of a corporate debtor for misappropriation of corporate assets. But the federal question jurisdiction carries pendent jurisdiction over nonfederal claims only if there is a federal claim with "substance sufficient to confer subject matter jurisdiction on the court." *United Mine Workers* v. *Gibbs*, 383 U.S. 715, 725 (1966). There can be no pendent jurisdiction where there is no federal claim whatsoever.

In short, before a federal court other than the Supreme Court can exercise any jurisdiction (1) Congress must have conferred that jurisdiction (2) on a court qualified under the Constitution to exercise it. The Supreme Court having decided in *Marathon* that the Article I bankruptcy courts are not qualified under the Constitution to exercise the jurisdiction Congress attempted to confer upon them by 28 U.S.C. § 1471, the effort of the Judicial Conference, and of others whose arguments we have addressed here, is to demonstrate that Congress also conferred that same jurisdiction on the Article III district courts. But all of these efforts involve tortured and unacceptable interpretations of other federal statutes which were enacted before the problem created by *Marathon* arose, and which were in no way designed to deal with that problem. Hence it was that a majority of the Supreme Court concluded that it would take further action by Congress after the *Marathon* decision "to determine the proper manner of restructuring the Bankruptcy Act of 1978 to conform to the requirements of Art. III, in the way that will best effectuate the legislative purpose" (102 Sup.Ct. at 2880, fn.40).

Even if this were not so evidently the case, and one or more of the various theories for finding bankruptcy jurisdiction in the district courts without further Congressional action were eventually to prevail, a failure of Congress to act or of the Court again to extend its stay by December 24, 1982, will still produce complete chaos in the administration of bankruptcy cases. Each of the various theories supporting district court jurisdiction is so tenuous that it is certain to be contested in the courts and another two years of litigation over jurisdiction will be necessary before the Supreme Court can resolve the matter.

2. The assumption that the federal district courts have authority to promulgate the proposed Judicial Conference rule.

The proposed rule itself invokes, as authority for its adoption by district courts, Bankruptcy Code § 105, §§ 404 and 405 of P.L. 95-598, FRCP Rules 53 and 83, and Bankruptcy Rules 513 and 927.

A. Bankruptcy Code § 105(a)

Bankruptcy Code § 105(a) provides that: "The bankruptcy court may issue any order, process, or judgment that is necessary or proper to carry out the provisions of this title" (emphasis added). As a matter of statutory construction, this provision does not reach the interim "courts of bankruptcy" created by § 404(a) of P.L. 95-598 to serve until new 28 U.S.C. § 151 takes effect on April 1, 1984, to create the new "bankruptcy courts," since § 405(b) of P.L. 95-598, while it gives the interim courts some of the new jurisdiction, does not give them that conferred by § 105. As a matter of statutory construction, also, a grant of jurisdiction under § 105(a) to "issue any order, process or judgment" is not a grant of jurisdiction to promulgate rules.

Section 105(a) is a near copy of now repealed § 2a(15) of the old Bankruptcy Act, which was also confined to orders, process, and judgments, and was never thought to authorize the promulgation of rules. (But the Administrative Office, which regards old § 2a(15) as "incorporated and preserved" by § 404(a) of P.L. 95-598, should be invoking old § 2a(15), which was at least addressed to "courts of bankruptcy," rather than new § 105(a), which applies to "bankruptcy courts.")

B. Sections 404 and 405 of P.L. 95-598

The proposed rule's invocation of §§ 404 and 405 of P.L. 95-598 as a source of district court rule-making authority is apparently again based on a misreading of those sections to vest bankruptcy jurisdiction in the district courts. See p.8, supra.

C. FRCP 53 and 83

FRCP 53, governing the appointment of standing and special masters by district courts, can hardly be stretched to authorize the district courts to promulgate the Judicial Conference's proposed rule, which would refer to the bankruptcy judges some or all cases within the jurisdiction defined by 28 U.S.C. § 1471(a) and (b) and which, like 28 U.S.C. § 1471(c), would authorize them to exercise jurisdiction in all such cases (with a single limitation not already imposed by new 28 U.S.C. § 1481 and § 405(a) of P.L. 95-598 forbidding the bankruptcy judges to conduct jury trials).

Subdivision (b) of FRCP 53 provides:

> A reference to a master shall be the exception and not the rule. . . . [I]n actions to be tried without a jury, save in matters of account and of difficult computation of damages, a reference shall be made only upon a showing that some exceptional condition requires it.

This provision obviously contemplates that references, even to a standing master, shall be reserved for exceptional cases and shall be done only on an individualized, case-by-case basis. Its requirements are not satisfied by a recital in the proposed rule that "exceptional circumstances exist" calling for a blanket reference to the bankruptcy judges of all cases under title 11 as well as all or most civil proceedings arising in or related to cases under title 11. As the Supreme Court said, in interpreting Rule 53(b) in LaBuy v. Howes Leather Co., 352 U.S. 249, 256, 259 (1957), and disapproving of a reference to a master of all issues of liability and damages in two antitrust cases of "unusual complexity of issues of both fact and law" by a district court whose calendar was badly congested and who had referred eleven cases to masters in the past six years: "The use of masters is 'to aid judges in the performance of specific judicial duties, as they may arise in the progress of a cause,' Ex parte Peterson, 253 U.S. 300, 312 (1920), and not to displace the court." From this decision others have concluded that, "with a few minor exceptions, references in nonjury cases run counter to the spirit and purpose of judicial administration in the federal courts," Kaufman, Masters in the Federal Courts: Rule 53, 58 Colum.L.Rev. 452, 459 (1958), and that, beyond the use of masters on matters of account and damages and to supervise discovery, "it is difficult to conceive of a reference of a nonjury case that will meet the rigid standards of the La Buy decision." 9 C. Wright and A. Miller, Federal Practice and Procedure 791 (1971).

The rule proposed by the Judicial Conference for adoption by the district courts is so at war with the letter and the spirit of FRCP 53 that FRCP 83, authorizing each district court to make rules "governing its practice not inconsistent with these rules," merely serves, not as authority for the proposed rule, but to accentuate its invalidity.

D. Bankruptcy Rules 513 and 927

This leaves, as possible sources of rule-making authority, only Bankruptcy Rules 513 and 927. Rule 513 provides only that, if a reference is made by a judge in a bankruptcy case (and the Advisory Committee's Note indicates that only a district judge is contemplated) to a special master, the Federal Rules of Civil Procedure shall apply. As indicated by the Advisory Committee's Note, only FRCP 52(a) and 53 refer to masters. Rule 52(a) provides only that: "The findings of a master, to the extent that the court adopts them, shall be considered as the findings of the court." And FRCP 53, as we have seen (pp.13-14) contains no authority for the adoption of the Judicial Conference's proposed rule. Moreover, § 405(d) of P.L. 95-598 provides that the existing Bankruptcy Rules are to apply only "to the extent not inconsistent with the amendments made by" P.L. 95-598 so that, if new 28 U.S.C. § 1471(c) forbids the district courts to exercise bankruptcy jurisdiction as we have argued (p.7) Rule 513 is no longer applicable.

That leaves only Bankruptcy Rule 927, authorizing district courts to "make and amend rules governing practice and procedure under the Act not inconsistent with these rules." Fortunately, it is not necessary to determine the full extent to which the existing Bankruptcy Rules are consistent with P.L. 95-598 and then to test the proposed Judicial Conference rule for consistency with the surviving Bankruptcy Rules. The proposed rule is inconsistent with FRCP 53 as incorporated by Rule 513 if the latter rule is not inconsistent with P.L. 95-598. If Rule 513 is inconsistent with new 28 U.S.C. § 1471(c) because § 1471(c) continues to forbid district courts to exercise bankruptcy jurisdiction, then so is Rule 927 for the same reason.

In sum, the theories invoked to find jurisdiction in the district courts to promulgate the proposed rule are as tenuous as the theories invoked to find other bankruptcy jurisdiction in those courts. And they are at least as provocative of litigation that will magnify the chaos in bankruptcy administration that will ensue if neither the Congress nor the Supreme Court acts by December 24, 1982.

UNWORKABILITY

Passing all questions as to the validity of the proposed rule and the litigation questioning its validity that it will provoke, the rule is on its own terms unworkable and provocative of additional litigation.

(1) Subsection (b)(1) refers to the bankruptcy judges "all cases under Title 11 and all civil proceedings arising in or related to cases under Title 11." The Administrative Office memorandum of September 27 accompanying the proposed rule states (p.2) that "all bankruptcy matters are initially referred to a bankruptcy judge" by this subsection. But the subsection, while it tracks the language of new 28 U.S.C. § 1471(a) in referring to "all cases under Title 11," omits the language of § 1471(b) covering "all civil proceedings arising under title 11." The omission invites litigation as to whether such matters as actions to recover preferences under § 547 or fraudulent conveyances as defined in § 548 and objections to discharge under § 727(a) are intended not to be referred to bankruptcy judges.

(2) This confusion is compounded by the provision in subsection (c)(3) that the judgments of bankruptcy judges "in civil proceedings related to cases under Title 11 but not arising in or under Title 11," that would be appealable if rendered by a district judge and that do not result from stipulation, shall not be effective and shall not be entered until signed by a district judge, with the

bankruptcy judge to submit findings, conclusions, and a proposed judgment to the district judge.

Does this provision contemplate that civil proceedings "arising under title 11" are not referred to bankruptcy judges, as subsection (b)(1) seems to imply? If so, what are the orders and judgments of bankruptcy judges under subsection (c)(2) (referred to in the Administrative Office memorandum (p.3) as "not involving a final judgment in a Marathon claim") that are effective upon entry unless stayed by the bankruptcy judge or the district court?

Or does subsection (c)(3) contemplate that such matters are referred to the bankruptcy judges despite the omission in subsection (b)(1) and that their orders and judgments in such matters are under subsection (c)(2) effective on entry unless stayed?

In any event, what are the judgments "not arising under Title 11" which require the signature of a district judge? For example:

> (a) Under § 502(b)(1) claims are not allowable if unenforceable against the debtor or his property under applicable law outside of title 11, usually state law. Does every ruling on an objection to a claim under § 502(b)(1) require the signature of a district judge?
>
> (b) Under § 522(b), a debtor may elect the exemptions provided by the law of the state of his domicile, or the law of that state may confine him to such state law exemptions. Does every judgment on an objection to a state law exemption require the signature of a district judge?
>
> (c) Under § 541(a)(1), property of the estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case." Nothing in title 11 provides a rule for determining when or to what extent a debtor has a legal or equitable interest in property. That will be determined under nonbankruptcy law, usually state law. Do all judgments on such determinations require the signature of the district judge?
>
> (d) Section 544(a) gives the trustee the hypothetical status of a judgment lien creditor and of a bona fide purchaser of real estate. But this will enable him to avoid unperfected prepetition transfers by the debtor only if he can locate some law, usually state law, outside of title 11, rendering such unperfected transfers voidable by judgment lien creditors or bona fide purchasers of realty. Does every judgment in a trustee's action under § 544(a) require the signature of a district judge?
>
> (e) Under § 544(b), the trustee may avoid prepetition transfers of property that any creditor with an allowable unsecured claim could have avoided under applicable law, usually state law, outside of title 11. Does every judgment in a trustee's action under § 544(b) require the signature of a district judge?

(3) Subsection (c)(3) also requires the signature of the district judge on every judgment "wherever otherwise constitutionally

required." While this provision adds nothing to what the Constitution would otherwise require, it provides no guidance to judges or practitioners operating under the proposed rule as to what is constitutionally required.

(4) Although subsection (c)(4) requires objections to be filed to orders, judgments, or proposed judgments of bankruptcy judges within 10 days after entry unless the time is shortened for cause by the bankruptcy judge or the district court, such objections are not necessary under subsection (c)(5) in order to insure district court review in any type of case:

> (a) For whatever is covered by subsection (c)(2), although no objection is filed to the bankruptcy judge's order or judgment, and although the matter was not controverted before the bankruptcy judge, the district court is required by subsection (c)(5)(A)(ii) to review it if the bankruptcy judge "certifies that the circumstances require" such review. Thus are the bankruptcy courts empowered, under no discernible standard, to refer cases for review to the district courts, who apparently must review and decide them although no party has objected or is interested in appearing to defend or challenge the bankruptcy court's ruling!
>
> (b) For cases "not arising in or under Title 11, or wherever otherwise constitutionally required," within the meaning of subsection (c)(3), the district court is required by subsection (c)(5)(A)(iii) to review the bankruptcy judge's proposed judgment before signing it, again although no party has objected or is interested in appearing to defend or challenge the bankruptcy judge's proposed judgment, although the parties can avoid this review if the bankruptcy judge has entered a judgment in what would otherwise be a subsection (c)(3) case that "result[s] from a stipulation among the parties."

(5) In conducting either of the above sorts of review, or in reviewing a subsection (c)(2) case on objection of a party, although one of the "exceptional circumstances" supposed to justify the proposed rule is "the specialized expertise necessary to the determination of bankruptcy matters," the district court under subsection (c)(5)(B) may take additional evidence and "need give no deference to the findings of the bankruptcy judge." (Although the Administrative Office memorandum states (p.3) that, if the bankruptcy judge has certified under subsection (c)(5)(A)(ii) that circumstances require review, the order or judgment of the bankruptcy judge is to be "confirmed.") Thus far we have come from FRCP 53, authorizing the district courts in exceptional circumstances to invoke the expertise of masters

whose findings of fact in nonjury cases are to be accepted by the court "unless clearly erroneous." Although the expertise is invoked in the proposed rule, it need be given "no deference."

(6) Finally, whenever under subsection (c)(6) the bankruptcy judge certifies, in any case subject to review by a district court, that "the circumstances require immediate review," the district court is to accomplish that review "as soon as possible."

Thus the proposed rule, because of its ambiguities in the employment and omission of categories employed in 28 U.S.C. § 1471 contains the seeds of multitudinous litigation. And, for the cases where no litigation results, it imposes on the district courts the burden of unaided review in which they need give "no deference" to the bankruptcy judge save for the bankruptcy judge's certification that the review must be expedited. The proposed rule does not chart a courts for "the orderly course of . . . business" (subsection (a)). It charts no intelligible course and creates only confusion.

Plainly, under the proposed rule, the district courts will have a heavy involvement in judgments and orders in bankruptcy cases because the uncertainties of the rule compel this involvement. Indeed, assuming this rule is understood to attempt to delegate dispositive power to the bankruptcy court over a given proceeding, it seems no overstatement to assert that any prudent party will decline to rely on a bankruptcy court's order respecting important matters even if they are undisputed, e.g., orders authorizing a negotiated extension of credit under § 364. Instead, he will want the assurance of a district court order. The district court judges for the most part simply have no time to respond to this increased workload. The inability to obtain prompt orders will make it impossible for bankruptcy administration to proceed efficiently.

ADDENDUM TO NATIONAL BANKRUPTCY CONFERENCE STATEMENT IN OPPOSITION TO PROPOSED JUDICIAL CONFERENCE RULE

Since preparation of its statement in opposition to the September 28, 1982, proposal of the Judicial Conference of the United States for a district court rule to deal with bankruptcy jurisdictional problems prompted by the decision in Northern Pipeline Construction Co. v. Marathon Pipe Line Co., 102 Sup.Ct. 2858, 103 Sup.Ct. 199 (1982), the National Bankruptcy Conference has received a copy of a December 1, 1982, proposal of the Administrative Office of the United States Courts for amendments to H.R. 7294 to deal with the same problems. Because these proposals seem to the National Bankruptcy Conference to be as invalid and even more unworkable than the proposed rule, the Conference submits this addendum to its prior statement.

There are currently 220 full-time and 21 part-time bankruptcy judges. H.R. 6978, as reported out by the House Judiciary Committee (H.R. Rept. No. 97-807, Sept. 15, 1982) provides for 227 new, Article III, bankruptcy judges to exercise the bankruptcy jurisdiction defined in 28 U.S.C. § 1471. The Judicial Conference had estimated that 300 new Article I bankruptcy judges would be needed to exercise the § 1471 jurisdiction before Marathon held § 1471 invalid because the bankruptcy judges were Article I rather than Article III judges. Although the current Administrative Office proposal would preserve the full scope of the bankruptcy jurisdiction as defined in § 1471 (to be redefined in a revised 28 U.S.C. § 1334), it proposed to eliminate bankruptcy judges entirely and to replace them with 120 "bankruptcy administrators" appointed in the judicial branch for five-year terms by the courts of appeals, 50 additional full-time magistrates whose number may increase to 75, and (if no restrictions are put on the other, nonbankruptcy, jurisdiction of the district courts) 115 additional district court judges.

Essentially, the scheme of the proposal is this:

(1) All bankruptcy jurisdiction is vested in the federal district courts.

(2) All voluntary bankruptcy cases and all "proceedings arising under title 11," but not proceedings "arising in or related to cases under title 11," are to be referred to the bankruptcy administrator. Where there is no contest, he may grant discharges, determine the priority of claims, appoint trustees, examiners, and creditors' committees, and "perform any other similar duty." The administrators are also to review and approve, or "file appropriate objection with the district court" to, inter alia, applications for employment of professionals and for compensation, disclosure statements under § 1125, reorganization plans under § 1128, and final reports of trustees. Further, the administrator is an "officer of the district court" and may refer matters to the district court and appear and be heard in such matters. Any contested matter arising before the administrator and any objection raised by the administrator are also to be referred to the district court. Any party may object to any action taken or proposed to be taken by an administrator by filing a notice of objection with the district court clerk within 10 days of such action or notice of proposed action, but if no objection is filed within that time the administrator's action or proposed action apparently is not reviewable.

(3) Apparently any matter arising in a bankruptcy case and before a district court may be referred to a magistrate under 28 U.S.C. § 636(b)(1)(B) for hearing and preparation of proposed findings and recommendations for disposition, subject to de novo determination but not necessarily to the taking of further evidence by the district court (see United States v. Raddatz, 447 U.S. 673 (1980)), but the parties may by their consent give the magistrate jurisdiction actually to decide the matter.

Specifically excepted from the "pretrial matters" under 28 U.S.C. § 636(b)(1)(A) which magistrates may dispose of, subject only to reconsideration by the district judge if "clearly erroneous or contrary to law," are allowance or disallowance of claims, stays, exemptions, priorities, accounts, discharges, "or any other application."

Invalidity

In the absence of timely objection, this proposal would have bankruptcy administrators, who may be "officers of the district court" but are not Article III judges, granting discharges, determining the priority of claims, and performing whatever else is contemplated by "other similar duties" within the meaning of proposed new 28 U.S.C. § 646(c)(8) not only in bankruptcy cases proper but in proceedings "arising under title 11." With consent of the parties, the proposal would also have magistrates, who also are not Article III judges, making final determinations not only in bankruptcy cases proper, but also in "proceedings arising under title 11" and in "proceedings arising in or related to cases under title 11" -- including the type of proceedings involved in the Marathon case itself.

But Marathon held that the constitutional doctrine of separation of powers precluded the vesting of jurisdiction -- at least over the debtor's state law claims against third parties and perhaps over all state law claims -- in other than Article III judges. We are aware of no authority for the proposition that private parties, by their consent or failure to object, can waive the separation of powers doctrine and vest Article III jurisdiction in other than Article III judges.

Since Marathon was a case where the defendant did object to jurisdiction over the subject matter, it is not surprising that the two concurring Justices speak of the bankruptcy court entertaining and deciding the lawsuit "over Marathon's objection" (102 Sup.Ct. at 2882) and that the three dissenting Justices speak of the Court's holding with respect to a bankruptcy court acting "absent the consent of the litigants" (102 Sup.Ct. at 2882) or "unless the defendant consents" (102 Sup.Ct. at 2884). But to try to patch these remarks into a majority decision that Article III jurisdiction can be conferred on other than Article III judges by consent of the parties is to ignore the well-established rule that jurisdiction over subject matter cannot be conferred by consent or waiver, and that absence of such jurisdiction should be raised by the trial tribunal *sua sponte* and, if not, by the court on appeal. *Clark* v. *Paul Gray, Inc.*, 306 U.S. 583, 588 (1939); *St. Paul Mercury Indemnity Co.* v. *Red Cab Co.*, 303 U.S. 283, 287 (1938); *Louisville & Nashville R.Co.* v. *Mottley*, 211 U.S. 149, 152 (1908).

This feature of the proposal, combined with the uncertainty as to what matters do and what do not require determination by an Article III court under the *Marathon* decision, will combine to provoke as much litigation over validity as would the earlier proposed Judicial Conference rule.

Unworkability

It is, at the outset, remarkable that, while one of the "exceptional circumstances" invoked by the Judicial Conference to justify its proposed rule is "the specialized expertise necessary to the determination of bankruptcy matters," the Administrative Office's proposal jettisons entirely the only people with expertise in the matter: the bankruptcy judges. In their stead it substitutes district courts, magistrates, and newly-created administrators, none of whom will have any bankruptcy expertise at all.

Moreover, save for the least important and most limited of these new functionaries -- the administrators -- it loads the additional bankruptcy responsibilities on judges and magistrates who will also be preoccupied with other civil and criminal litigation and leaves no one in the position presently occupied by the bankruptcy judges, who are exclusively available promptly to handle the disputes that continually and invariably arise in bankruptcy cases. The result will necessarily be additional delay and expense in the administration of bankruptcy cases which will prejudice both debtors and creditors.

More delay and expense is built into the Administrative Office's proposal. All voluntary cases and all "proceedings arising under title 11" are referred in the first instance to bankruptcy administrators. While their functions are to be limited, the limitations are unclear. But any party wishing to protect itself against the administrator's action or proposed action must be represented and prepared to file an objection within 10 days or apparently forfeit review of that action or proposed action by the district court. Any matter which does come before the district court, whether on review of the administrator's action or otherwise, may be (and most doubtless will be) referred to a magistrate. Then, unless the parties consent to final disposition by the magistrate, he must after hearing forward proposed findings and recommended disposition of most matters back to the district court for a dispositive order. The delay and expense thus built into the proposal is as inevitable as it is unnecessary.

In addition to the additional litigation bound to be produced by this bouncing of disputes from one tribunal to another, ambiguities in the proposal are certain to provoke further litigation. Proceedings "arising under title 11" are referred to the bankruptcy administrator but proceedings "arising in or related to cases under title 11" are not. While this appears to be a reverse of the types of proceedings that were to be referred to bankruptcy judges under the Judical Conference's proposed rule, it will produce the same sort of litigation over the boundaries of each category.

While apparently all matters within the bankruptcy jurisdiction may be referred by the district courts to magistrates, the nature of the magistrates' treatment of matters varies. For most matters they may only conduct hearings and submit proposed findings and recommended orders back to the district judges.

Generally, under 28 U.S.C. § 636(b)(1)(A), magistrates have a greater authority as to certain "pretrial matters." They may enter decisions that are not to be reconsidered by the district court unless "clearly erroneous or contrary to law." But the Administrative Office's proposal would confusingly amend § 636 (b)(1)(A) to exclude from these "pretrial matters" not only the allowance or disallowance of "a claim, a stay, an exemption, a priority, an account, [or] a discharge" (many of which can only be resolved after trial), but also "any other application." This proposal can only produce additional wasteful litigation about what matters are "pretrial" in the bankruptcy context and which are to be initiated by "application" rather than by motion or by complaint.

In short, the Administrative Office's proposed legislation is rivaled only by the Judicial Conference's proposed rule in its capacity for provoking more litigation, delay, and expense in the administration of bankruptcy cases, all to the only apparent purpose of avoiding giving the bankruptcy judges the constitutional status necessary to enable them to administer the bankruptcy system in the most efficient way possible.

Senator **Dole**. We now have another panel on the Consumer Credit Code Amendments.

STATEMENTS OF HENRY SOMMER, NATIONAL CONSUMER LAW CENTER; LAURENCE GOLD, SPECIAL COUNSEL TO THE AFL-CIO; AND HOWARD MARLOWE, ASSOCIATE DIRECTOR OF LEGISLATION, AFL-CIO

Senator **Dole**. Again, if I could urge the panel to summarize your statements, they will be made part of the record. We would like to have some time for questions, and the witnesses yet to be heard, the Agricultural Produce Bailment amendments, Repurchase Agreement Code amendments, Shopping Center Tenancy amendments, and Timesharing Agreements amendments. I would suggest there is no opposition to those bills.

Who wants to start?

Mr. **Sommer**. I am Henry Sommer, and I am an attorney at Community Legal Services in Philadelphia. I have been asked to be the spokesperson for the National Consumer Law Center, and I appreciate the opportunity to testify on these matters relating to consumer bankruptcy.

A great deal has been said and written about the proposals that originated with the credit industry and the study that industry produced to justify the proposals. I have dealt with many of the issues relating to those proposals in my written statement, and I will not take the time to discuss them here. I would ask that my statement be included in the record.

Most of the debate that has gone on thus far about these proposals has assumed that they will work as they are envisioned on paper and in theory. That is, a creditor will file a motion to dismiss, because the debtor is supposedly able to pay his or her debts. There will be some kind of a trial, there will be a decision on the issue, whether fair or unfair. I suggest in my written statement why I think it is going to be difficult to have uniformly fair decisions in such cases, and then the debtors, if they are not allowed to remain in chapter 7, will convert to chapter 13, and the creditors will be paid.

From my experience of handling consumer bankruptcy cases for 8½ years, I can say that this vision of how these proposals will work in theory is very different from what is likely to actually happen in practice.

In those cases that do get litigated, the debtors are not going to convert to chapter 13. These are people who have gone into chapter 7 because they feel they cannot pay their debts. Just because the judge says they can does not mean that they will suddenly agree that they can. They will still feel unable to pay and the case will just be dropped.

The debts listed in the bankruptcy petition will remain unpaid, just as most had been unpaid prior to the case. The consumers will continue to have a load of debt on them and will be denied a fresh start. The creditors, who rarely file suit to collect their debts, will be no better off.

But more importantly, the vast majority of the cases will go down a different course. This bill will be used by creditors to force unfair reaffirmations just as they used the household goods security interests and the false financial statement provisions under the previous Bankruptcy Act.

The reason they will be unable to do this is that, as we know, most litigation is settled. That is especially true here, where you have debtors who have used their last $300 or $400 to file the bankruptcy case and do not have the money to pay $300 to $500 more to their lawyers, up front, to defend motions filed by creditors.

But the settlement reached won't be to have the debtor convert to chapter 13. The creditor's lawyer will say, "You reaffirm my debt, and I will drop the proceeding." This is what the creditor wants. His debt gets reaffirmed and all others get discharged. The creditor has no interest in forcing a debtor into a chapter 13 where he will have to share the debtor's income with all other creditors. Unfortunately, for the debtor, compared to paying $300 immediately to his attorney to defend against the motion, with the possibility he may still lose, the creditor's offer may look like the least bad alternative available, and it will often be accepted.

The result of passing the proposals that were in S. 2000 would be to bring back all of the abusive situations we had under the act and others that would result in even worse burdens for debtors by causing unfair reaffirmations through these new provisions as well.

As I discussed in my written statement, even under the creditors' most optimistic estimates, only a small fraction of consumer debt outstanding, a small fraction of 1 percent, could be collected under the proposed threshold test.

With all respect to this committee, I believe that there are more pressing problems that need to be addressed at this time. One such problem is of course the current situation of the bankruptcy courts. Another, which I see daily in my practice is a crisis which is developing in this country around unemployed homeowners and farmers facing foreclosures on their homes and farms. Currently, chapter 13 does not offer adequate remedies for this problem. The only thing a person can do under chapter 13 is cure a default, that is, pay current payments, plus something toward arrearages. This offers little help to those who cannot now afford even their current payments.

During the Depression, the Congress passed moratorium relief, which was upheld by the Supreme Court, which allowed debtors to reduce their payments or defer their payments for a period of time. I would suggest that for the thousands of families who right now stand to lose their life savings and equities in their homes and farms and perhaps all their hopes for the future that arise around that, that that is a very serious problem that this committee ought to immediately address, and is a more important problem than the small fraction of 1 percent of consumer debt outstanding that might be affected by the current creditor proposals.

Senator DOLE. I think the last thing you mention is of particular interest, and we hope to have hearings soon on farm bankruptcy hearings, and perhaps any information you have would be helpful to our staff.

Mr. SOMMER. Being from Philadelphia, I do not have too many clients with farms, but I do represent quite a number of unemployed home owners.

Senator DOLE. There are a number of questions, including not only that particular area, but others.

Mr. SOMMER. Thank you.

Senator DOLE. Mr. Gold?

Mr. GOLD. Mr. Chairman, on behalf of the AFL-CIO, I appreciate the opportunity to present our views on the bankruptcy law issues now before Congress. We do not pose as experts on all of these issues, and we wish to address three points.

First, in the range of current bankruptcy issues, none is more urgent than placing the bankruptcy system on a sound constitutional basis.

Of the various approaches that have been mentioned, the AFL-CIO opposes one and supports any of three others.

We oppose any legislation that would confer article III status on bankruptcy judges, and would allow those judges to be assigned to sit even temporarily on other matters in other courts. That would not insure that bankruptcy judges would concentrate their attention on the field of law with which they are familiar, or the expeditious handling of bankruptcy cases. Aside from these practical considerations, we believe permitting a large number of specialists contemplated to man the bankruptcy system to become an integral part of district and circuit court judges would work an undesirable transformation of the Federal judiciary. Heretofore, it has been generally agreed that article III judges should not be narrow specialists, but should be broadly familiar with all facets of Federal law. Even with all the imperfections of the judicial system, we cling to that agreement as stating a sound ideal.

In contrast, we suggest that any of the following alternatives make good sense.

First, providing for article III bankruptcy judges who may only hear bankruptcy cases, and who may not be assigned to sit on the district courts or courts of appeals either as a separate step or in conjunction with the administrative steps suggested by the Judicial Conference. Second, providing a so-called two-tier system of both article III and nonarticle III judges. And, third, a statute of limited duration to provide a legislative predicate for the interim Judicial Conference rules presently in effect.

We do insist that all these steps should be taken before turning to other matters. As much as any other factors linking the constitutional problem I noted with S. 2000 has been responsible for the deadlock on how to respond to the Supreme Court's mandate. We do not object to a rational correction of the consumer bankruptcy provisions and to a correction in errors in the 1978 act, if there are any, but we are convinced that there can be no such reexamination in conjunction with the already difficult task of reforming the bankruptcy court system and doing so in a timely fashion.

Second, during the last Congress, the Senate Judiciary Committee reported out legislation to make major changes in the consumer bankruptcy provisions. This bill was a response to credit industry claims that personal bankruptcy filings have increased due in large part to the changes made in 1978.

We have grave doubt of the accuracy of those claims. Since the accuracy of those claims has already been put into question by the two preceding witnesses, we only note that we have covered the point in our testimony.

Most important, it is our view that taken together, S. 2000 would have shifted the current balance between creditors and debtors to favor the creditors. As the gentleman who preceded me has noted, however fair these proposals may have seemed in the abstract, given the comparative resources available to creditors and to debtors, the changes proposed, which in almost every instance placed the transaction costs on the debtors, would have altered the system and to the debtors' disadvantage.

Finally, we would be remiss if we did not point out a problem now before the Supreme Court in a case called *National Labor Relations Board* v. *Bildisco & Bildisco.*

As the Solicitor General stated in the petition for certiorari, that case raises significant and recurrent questions concerning accommodation of the policies underlying two statutory schemes, the National Labor Relations Act and the Bankruptcy Code.

In large part, the conflict as to the scope of those two statutes results from disagreements as to the effect of the 1978 bankruptcy law amendments on the interplay between that law and the national labor law.

Where the legal questions are at bottom ones of policy, and the *Bildisco* case questions most certainly are, we believe a legislative answer is to be preferred to a judicial answer. True to the position we have taken on the consumer bankruptcy issues discussed above, we nonetheless believe consideration of this issue vital to collective bargaining should await the signing of a Northern Pipeline bill. At that time, it would be our hope that the subcommittee would as part of its overall review of the substantive bankruptcy issues, make it absolutely plain that bankruptcy is not a means of overturning valid collective bargaining agreements.

Thank you.

Senator **Dole**. Do you have any comments?

Mr. **Marlowe**. No.

Senator **Heflin**. Do you foresee any problems in the workmen's compensation field of a bankruptcy, some in administrative agencies and some in courts, having distinctions as to how those things might be determined if all were brought into a bankruptcy court?

Mr. **Gold**. Grave questions are raised by the *Manville* case. It is an unprecedented use of the bankruptcy system, as Professor King noted, and it is far from clear that it is a proper use of the system, particularly with regard to future and inchoate claims.

We incline toward the view that it is a misuse of the system. If you are going to have a future income test at all, a business that is presently profitable and liquid ought to be subjected to that test rather than individuals who have no present income and about whom you are making a hypothesis concerning the future. Narrowing the scope of the bankruptcy law to make it plain that *Manville* is in the wrong forum may well be the right legislative solution.

On the other hand, it is our view that in the present state of the economy, we need a functioning bankruptcy court system, and one that meets the Constitution, and, therefore, we refer to the point we stressed, that the *Northern Pipeline* question is the overriding question—as interesting and as difficult as questions about plenary jurisdiction, the interplay between the labor laws and the bankruptcy laws, or the status of inchoate future claims may be, those have to take a secondary, backseat status for the moment.

Senator **Heflin**. Do you have any suggestion as to a possible solution to the problem where individuals who can pay their debts, nevertheless file straight bankruptcy? Do you have any solutions as to those that clearly have the future ability to pay their debts? Do you have any suggestions as to how that could best be handled?

Mr. **Sommer**. I think one thing that could be done would be a provision akin to the false financial statement dischargeability provisions that already exist. A number of restrictions would have to be placed upon it but such a provision could allow an individual creditor who supposedly relied upon a person's income, and who could show that it was reasonable to rely on the person's income, that the debtor's circumstances have not changed, and that the debtor is able to pay his or her debts, to have the debt held nondischargeable. Then you would be talking about only that individual creditor, and not one who perhaps unreasonably relied upon income.

Another provision would have to be a strong attorney's fees provision. Without that provision, the cases are never going to get to court, because the debtors cannot afford to pay their attorneys to litigate them. And if you have an attorney's fees provision, it would have to say something more than the provision that was in S. 2000, which I see to be only a restatement of the common-law rule that has always allowed attorneys' fees where there is bad faith. I think that to allow an individual creditor to bring such an action would not be unreasonable. That is what would happen in reality, under the current proposals where, as I have explained, a reaffirmation to that individual creditor who files a motion is going to be the ultimate result.

Mr. GOLD. There are ways of narrowing the problem—by distinguishing between hypothetical and real income flows, for example. And neither on that question nor on questions like the "loading up" problem do we think that the present law is perfect. But any system has to take into account that the petitioner in bankruptcy has very limited resources. To the extent that Congress gives new leverage to the creditors by giving the creditors new legal grounds to explore, and the bankrupt has to respond as best he can with the most limited terms, the result will be reaffirmation of debts or people walking out of the bankruptcy system and simply not paying their bills.

Senator DOLE. Thank you very much. We will be in touch on the other matter.

Mr. SOMMER. Thank you.

Mr. GOLD. Thank you.

[The prepared statements of Messrs. Sommer and Gold follow:]

PREPARED STATEMENT OF HENRY J. SOMMER

My name is Henry J. Sommer and I am a legal services attorney specializing in bankruptcy and consumer matters. For over eight years, I have represented families and individuals residing in Northeast Philadelphia who have sought the help of our office for serious debt problems. I am grateful for the invitation of the subcommittee to come before it to relate some of my experiences in that endeavor which are relevant to the Bankruptcy Code amendments now being proposed.

It is my understanding that the subcommittee is considering a bill that would include most of the provisions contained in the final version of S.2000 as reported in the last Congress. For the low-income clients that I represent, as well as the more middle income cases I observe regularly in bankruptcy court, that bill is no more necessary or satisfactory now, in the midst of the worst unemployment since the 1930's, than it was before.

The pros and cons of the provisions in S.2000 and its House counterpart, and particularly the threshold test for chapter 7, have by now been the subject of extensive debate. All parties have drawn their own conclusions from the increased numbers of bankruptcy filings, most of them ignoring the documented impact of interest rates, the explosion of lawyer advertising, and the fact that much of the increase (and almost all of it in the district where I practice) has been in chapter 13 cases. Few have noted that the number of filings also includes an enormously increased number of cases eventually dismissed by the courts, cases which have no ultimate effect on creditors.

The serious defects in the study sponsored by creditors to provide justification for their proposals are also now well known. In addition to the fact that the authors of the study have long been associated with credit industry groups, they have refused to allow verification of their results by withholding the underlying data upon which they are based. Moreover, the conclusion that significant numbers of debtors could "pay their debts" and didn't need chapter 7 is based on a host of faulty assumptions. Among these were that consumers would and could reduce their expenditures to near poverty levels, that their income would keep up with inflation, and that none of them would lose their jobs, have serious medical problems causing loss of income or increased expenses, have marital separations or additional children, or have any other unanticipated increases in their expenses. Even using these highly unrealistic assumptions, the creditor study found that if every one of those debtors filed five year chapter 13 plans, the net gain for creditors would amount to, at most, a small fraction of one percent of total consumer credit outstanding.

And, of course, most of that money would never really be collected. The so-called "bankruptcy losses" of creditors are made up largely of unsecured debts that would never have been collected regardless of whether bankruptcies were filed by the debtors involved. In my experience most debts listed in bankruptcy petitions have not been paid for months because the debtors have felt themselves unable to pay. These same debtors are not likely to file chapter 13 cases if they are barred from chapter 7. The only results will be that the debts will remain unpaid and the debtors will be deprived of any relief from crushing loads of debt they feel they cannot repay.

Furthermore, even the current creditor proposals do not require that every one of the debtors who are supposedly able to pay some debts be barred from chapter 7. Those who could not pay a reasonable percentage of their debts would not be forced into chapter 13, so that any amounts they theoretically could have paid must be subtracted from the amount creditors claim they could realize from chapter 7 debtors. An additional ten percent of any payments that actually were made (or even more under the proposed technical amendments) would also be subtracted as the chapter 13 trustee's fees. After all of these deductions, the amounts that might actually find their way to creditors would be only a tiny fraction of what they claim could in theory be repaid. What creditors would realize, then, would be a tiny fraction of the already small fraction of one percent that their study claims they now lose. It is quite likely, in fact, that the cost to the taxpayers of funding the expensive judicial debt collection machinery such a bill would necessitate would be greater than the additional amounts collected for the creditors.

Why then are the creditors pushing so hard for these provisions? My strong suspicion is that they know, as I know, how these provisions will operate, in the real world of consumer bankruptcy, to deter all debtors, not just those supposedly able to pay their debts, from filing bankruptcy cases. This will happen because the provisions proposed, especially taken as a group, will give creditors a wide array of methods to make consumer bankruptcy more difficult, expensive, and intimidating, and to obtain leverage to force reaffirmation of consumer debts.

Virtually every provision in the creditor bill seems to lead to this result, beginning with the revitalization of false financial statement dischargeability complaints (which would no longer be deterred by an effective attorney's fee provision)[1] and household goods security interests. These weapons in the creditor's arsenal, consistently found by every impartial pre-Code study to force unfair reaffirmations under the Bankruptcy Act, would be greatly enhanced by new ones.

Just as creditors could, under prior law, force reaffirmation by commencing false financial statement litigation that the debtor could not afford to defend, they could file motions to dismiss chapter 7 cases under the future income test. Debtors would be faced with a prospect of losing money, their own attorney's fees, payable immediately, even if they won their cases. Just as occurred in the old dischargeability cases, a creditor's offer of withdrawal of the motion in exchange for a reaffirmation would seem attractive to many, perhaps the only thing they could afford. Indeed, a reaffirmation coerced in this manner would be the creditor's usual goal. The typical creditor would much rather achieve this result than force a debtor into a chapter 13 case where it would have to share the debtor's scanty disposable income, if any existed, with all other creditors.

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[1] I do not understand the purpose of the proposed replacement for the current 11 U.S.C. § 523(d), or the attorney's fee provision related to the future income test, unless they are simply meant to give the appearance of deterrence. Their language seems merely to be an unnecessary restatement of the current common law bad faith exception to the "American rule" that each party normally bears its own fees. If something stronger is intended that certainly should be made clear by a change in language or legislative history.

Similarly, debtors would have to expend funds for an attorney to rebut the presumption of "loading up," even in cases where the lack of dishonesty was obvious.[2]

They would be forced to pay an artificially high value to redeem collateral securing consumer loans, a greater amount than a creditor would realize through repossession, if they chose not to reaffirm such debts--a choice forced upon them almost immediately after filing of the case. I fail to see any rationale for this type of bonus to creditors that would be required upon the misfortune of a debtor's bankruptcy.

The necessary final piece of the scheme is the removal of all meaningful restrictions on reaffirmations. Once more, taken alone this proposal would be merely an unwise step backward. But combined with all of the levers creditors would be given to force reaffirmations it would seriously undermine the fresh start that bankruptcy has always been meant to provide.

My greatest concern about these proposals is that they will not, in practice, be restricted to those middle income debtors "who can really pay their debts," as the creditors have consistently maintained in these hearings. My experience in the real world of daily dealings with creditors and collection attorneys leads me to believe that even the poorest debtors will be affected if the creditor proposals become law. While it may be stated here by creditors that they are not interested in pursuing that majority of bankruptcy debtors who according to all of the studies cannot pay their debts, it is my experience that the local representatives of those creditors systematically and aggressively seek payments from low-income families. Each one expects, and indeed demands, that some substantial monthly portion of the family's very meager funds, perhaps $10, $20 or $30 a month, be devoted to paying off that one creditor's obligation. In order to extract payments which welfare families cannot afford, the creditors of my clients have on many occasions scheduled sheriff sales of all of a family's household goods, or of a family's home. In fact, in many of these same cases my clients have literally been forced into bankruptcy court when creditors have refused offers of settlement my clients could afford, even though they were made fully aware that the only other alternative my clients had was that of bankruptcy, in which the creditors fared far more poorly.

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[2] The potential burden on the bankruptcy courts from this particular provision, in addition to the future income test, is enormous. Most debtors have debts for necessities, such as utilities, incurred within forty days prior to filing that were not the result of "loading up." If even half of these debtors filed the adversary proceedings required by the rules to determine the dischargeability of such debts, the annual number of adversary proceedings in the already overloaded bankruptcy courts would be more than doubled by this provision alone.

In other words, many individual creditors apparently have a very different conception of who is able to pay their debts than has been presented by their industry representatives in these hearings. I have no reason to believe that under the current Senate proposals these creditors would not strongly press these views in the bankruptcy courts, in cases of my low-income clients, just as they currently do both outside and inside the local state courts.

Nor am I confident that the current proposals as presently drafted will assure that those creditors' pleas will be unsuccessful in the bankruptcy courts. Although the stated purpose of the bill is to protect creditors who have reasonably relied upon a debtor's future income in extending credit, there is no provision in the bill which provides that a creditor's motion for dismissal will be denied in any case where the debtor's circumstances have changed since the time of the original debt was incurred (as opposed to the time of a refinancing) or where the future income which was relied upon is no longer present. Indeed, the bar to a chapter 7 discharge is not even limited solely to those creditors who can show they have relied on future income.

Similarly, the current bill would presumably allow creditors to argue that they relied upon the future income even of very low income debtors. I have seen instances of substantial credit extended to people receiving public assistance, even where those debtors had just filed a bankruptcy case. There is no reason why such improvident extensions of credit should be protected, and yet the bill does not require a creditor to show either that its reliance on future income was reasonable or that the debtor presently has a substantial income with which debts could be easily paid as they came due.

Without such basic criteria I am fearful that some bankruptcy judges will find even welfare recipients able to pay some portion of their debts through a further diminution of the already spartan standard of living to which they have had to become accustomed. There is nothing in the bill which limits the application of the future income test to those middle and upper income people for whom it is supposedly intended.[3]

A few hypothetical situations may illustrate the inherent difficulties that bankruptcy judges will face in making these determinations, as well as the unavoidable potential for unfairness. How is a judge to compare, for example, a welfare family which pays $80 a month for rent with a family somewhat better off that pays $350 or $400 a month, a rent higher than the welfare family's total income? The welfare family often has no choice but to live in substandard housing, which is all that it can afford. Yet, we are all aware that to obtain a decent apartment in many of our large cities a family cannot pay much less than four or five times the welfare family's rent. The welfare family has no automobile and the other family has a relatively new one, with $3,500 in annual loan and insurance payments, which is essential for the husband's daily 60-mile roundtrip to work. The better off family may be in the middle of paying for an orthodontist, and a secured installment purchase of moderately priced furniture and appliances, and parochial school tuition for several children, and other goods or services that many people consider important or necessary, but which the welfare family could never afford.

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[3] The current proposed definition of persons who can pay a reasonable percentage of their debts is also extremely overbroad when compared to what the creditors say they wish to accomplish. If the purpose is to determine who should be allowed into chapter 7, the test should look only to those unsecured claims that will be affected by a chapter 7, and not to secured claims such as second mortgages and automobile loans that are protected by their liens in a liquidation case. It therefore makes no sense to look to what percentage of total debt (excluding only first mortgages) a debtor can pay. Many, and perhaps a majority of debtors may be able to pay all or most of their mortgage debts and yet be totally unable to pay any of their unsecured debts. Under the test now proposed, all such debtors, who can afford to pay none of their unsecured debts, would be barred from chapter 7 unless they could meet the affirmative burden of proving hardship.

It is certainly possible that, faced with the case of the welfare family, a creditor would argue, and a judge might agree, that because the fixed expenses of the welfare family were very small, only $80 for housing, and so forth, that the family could afford to pay $10 or $20 a month to its unsecured creditors. At the same time a different judge, or even the same judge, might well find that a family living much more comfortably, on an income four times as great, had fixed expenses so large that it could not afford to pay anything to its unsecured creditors. Few would argue that the second family should be required to give up its apartment and move into substandard housing, or give up its car, or its furniture and appliances. Yet, there is a very real likelihood that without a relatively high income floor for any future income test, there will be a tremendous disparity and unfairness in the way it is applied, with poorer families often required to make far greater sacrifices for their creditors, ironically, because they are poorer. And even those families who succeed in running the gamut of the future income test will have gained no real victory, absent an effective attorney's fee provision for prevailing debtors, since they will still have had to pay hundreds of dollars for their own attorneys.

Such examples as I have given demonstrate the difficulties, complexities, and potential inequities any future income test would entail. Contrary to the arguments of the creditors, the application of such a test would not be a simple matter. Their unstated assumption, suggested by their graphs and charts, that a court can draw a bright line demarcating where necessities end and excess income available for debts begins is simply incorrect. Also in error is the implication in their argument that the future income test will not affect the majority of debtors who are low-income people, at least if there are no concrete protections of the sort I have suggested.

Fundamentally, these problems arise from the creditors' desire to have the bankruptcy courts, and the bankruptcy law, do what it has never done before--serve as a combination collection agent and support court, determining what standard of living a family should be allowed and extracting ongoing involuntary payments for creditors, as a condition for granting a fresh start in life.

The magnitude of the change Congress is being asked to make is illustrated by the fact that even a debtor who is subject to being put into an involuntary chapter 7 case under current law (for generally not paying debts as they come due) may be ineligible for chapter 7 under the creditor proposals. This may well mean that creditors of small business proprietors will no longer have involuntary bankruptcy available to them as a remedy. On the other hand, one can only assume that individuals starting small businesses will be greatly deterred from doing so by the new unavailability of chapter 7 relief if their business fails. A primary purpose of bankruptcy--to encourage the risk-taking entailed in starting a new venture in our free enterprise system--will thus be thwarted.

The interrelationship of the current creditor proposals with unvoluntary bankruptcy and small "mom and pop" businesses has so far received scant attention. It was probably of little concern to the consumer credit industry in its fervor to protect its own interests. It should be of greater concern to this subcommittee.

Finally, although I have not covered every detail of the proposed consumer amendments, I must make clear my opposition to virtually all of the changes now suggested in the Senate draft. These anti-consumer amendments seem particularly ill-timed during a period in which more Americans are out of work and in need of bankruptcy relief than at any time in recent memory.

With all respect, this committee has spent sufficient time on creditors' attempts to save the small fraction of one percent of consumer credit outstanding that they claim their scheme could recover. There are other issues which have become far more pressing.

There is a crisis developing in this country for tens of thousands of unemployed homeowners and farmers faced with imminent mortgage foreclosures. These families stand to lose large equities, often representing their life savings and their hopes for the future, in foreclosure sales to speculators at bargain basement prices. The rate of mortgage foreclosures is higher than at any time since the Great Depression.

Unfortunately, the current bankruptcy laws are woefully inadequate to deal with this problem. The most that a debtor can do in chapter 13 is cure a mortgage default, i.e. pay the current payments plus an additional amount towards arrears. This offers little help for the many who cannot afford even their current payments.

During the depression the Congress reacted to a similar situation by amending the bankruptcy laws to provide greater relief. That kind of emergency action is needed once more, to provide in chapter 13 for modification of mortgages to allow a reasonable moratorium period of reduced or postponed payments, which could then be amortized over the postmoratorium life of the mortgage, or after the due date for the last mortgage payment.

In Pennsylvania, where I live and work, I see this crisis daily in my cases. My legal tools for dealing with the plight of such families are inadequate. The thousands of families who have worked and saved to own their own homes and farms deserve protection. I respectfully submit that theirs is a far more urgent and important problem than that of the consumer creditors who seek to enhance their profits by the tiny percentages sought in the current proposals, a problem which should be given immediate attention.

PREPARED STATEMENT OF LAURENCE GOLD

On behalf of the AFL-CIO, I appreciate this opportunity to provide a summary of our views on certain of the important and difficult federal bankruptcy law issues now before Congress.

Of the range of current bankruptcy issues, none is more urgent than placing the bankruptcy system on a sound constitutional basis. Northern Pipeline Construction Co. v. Marathon Pipe Line Co., ___ U.S. ___, 50 L.W. 4872 (June 28, 1982) holds that the bankruptcy court system established by Congress in 1978 does not meet the requirements of Article III of the Constitution. Recognizing the gravity of the matter, the Court twice stayed its mandate to permit Congress to act, but it did not prove possible to pass new legislation. On December 24, 1982 the Court's judgment went into effect.

The current high rate of business bankruptcies makes the expeditious resolution of the status of the bankruptcy courts imperative. Of the various approaches that have been mentioned, the AFL-CIO opposes one and supports any of three others.

We oppose any legislation that would confer Article III status on bankruptcy judges and allow those judges to be assigned even temporarily to sit on other matters in the district courts or courts of appeals. Such an approach would not assure that bankruptcy judges concentrate their attention on cases involving the intricate field of law with which they are familiar or the expeditious handling of bankruptcy cases. If bankruptcy judges were to be permitted to hear non-bankruptcy cases, there is a clear possibility that such non-bankruptcy cases would take precedence over pending bankruptcy litigation. Aside from these practical considerations, we believe that permitting the large number of specialists contemplated to man the bankruptcy system to become an integral part of the complement of district and circuit court judges would work an undesirable transformation of the federal judiciary. Heretofore, it has been generally agreed that Article III judges should not be narrow specialists but rather should be broadly familiar with all facets of federal law. Even with all the imperfections of the judicial system, we cling to that agreement as stating a sound ideal.

In contrast, we suggest that any of the following alternatives make good sense:

First, providing for Article III bankruptcy judges who may only hear bankruptcy cases and who may not be assigned to sit on the district courts or courts of appeals.

Second, providing a so-called two-tiered system for the appointment: (1) of a substantial number of non-Article III bankruptcy judges in each judicial district who would sit only on those cases in which there is no Northern Pipeline problem or in which all parties agree that such a judge may preside; and (2) a small number of Article III judges who would preside in the remaining bankruptcy cases.

Third, a statute of limited duration to provide a legislative predicate for the interim Judicial Conference rules presently in effect. Such a statute would reduce the current uncertainties and thereby tend to stabilize the situation while Congress debates the merits of the alternative long-term answers that have been suggested.

During the "lame duck" session of Congress last year, some members of the credit industry sought to use the Northern Pipeline decision as a lever to secure passage of what the AFL-CIO firmly believes to be ill-conceived changes in the federal consumer bankruptcy laws. As much as any other factor, this effort has been responsible for the deadlock on how to respond to the Supreme Court's mandate. The AFL-CIO does not object to a rational reexamination of the consumer bankruptcy provisions and to a correction of errors in the 1978 Act if there are any. But we are convinced that there can be no such reexamination in conjunction with the already difficult task of reforming the bankruptcy court system and doing so in a timely fashion. Those in the credit industry who would tie a resolution of the Northern Pipeline issue to substantive changes in the bankruptcy law are doing a disservice to the many businesses, institutions and individuals who are now — or will soon be — embroiled in bankruptcy proceedings.

During the last Congress, the Senate Judiciary Committee reported out legislation to make major changes in the consumer bankruptcy provisions. This bill (S. 2000) was a response to credit industry claims that personal bankruptcy filings have increased due in large part to the changes made in 1978. The facts, however, indicate that such filings as a percentage of loans outstanding have remained at a stable level over the past few years. The credit industry has also claimed that personal bankruptcy has become a haven for "deadbeats" — those who are undeserving of its relief. Once again, the facts tell a quite different story. Over the past 20 years, the profile of the typical bankruptcy petitioner has not changed. It remains a 30- to 40-year-old, married, blue collar worker with two or three dependents, paid hourly wages at an annual rate of about $12,000 in today's dollars. That individual is likely to have suffered a recent layoff or perhaps a disability, divorce or a major and uninsured illness. At a time where there are no jobs, when interest rates are high, and when federal assistance has been reduced, an individual in this position cannot find a way to get by. The credit industry insists, too, that that abuse of the bankruptcy law is costing more than $1 billion each year. Once again, the facts show the contrary: total bankruptcy losses for all consumer creditors have remained remarkably constant over the past 20 years — about 1 percent of all consumer debt outstanding. Put in perspective, that means 99 percent of all loans are being paid off, even in these hard times. In short, the credit industry's showing on why legislation is needed is hardly persuasive.

The credit industry claims that it does not want to make life any harder for the typical bankrupt, but the proposals put forward belie that claim. Taken together, S. 2000 would have shifted the current relatively equal balance between creditors and debtors to favor the creditor. The proposals contained in S. 2000 were little more than an effort to give special consideration to the credit industry in this time of national economic crisis by having the bankruptcy courts serve as a debt-collection agency with taxpayers footing the bill.

A centerpiece of the credit industry proposal last year was the so-called "future income" test. As set out in the bill reported by the Senate Judiciary Committee test could narrow the availability of Chapter 7 bankruptcy relief to exclude those who are deserving of that relief. Critical terms such as "reasonable portion" and "substantial percentage" received only vague definitions in the bill and the accompanying committee report, while the central term — "anticipated future income" — was not defined at all. Such a provision, we believe, by reason of its complexity would be a means of discouraging consumers from filing for bankruptcy.

While the "future income" test has received the most attention, it is only one of many similar proposals — all slanted in favor of the creditor. For example, in cases where a creditor has failed in a motion to dismiss a bankruptcy petition on the ground the debtor is ineligible, the credit industry would deny repayment of the debtor's attorney's fees unless the motion "was not filed or pursued in good faith." This would add a significant additional cost to debtors who can ill afford another bill even in a situation in which the debtor prevailed. Even Shylock would have been ashamed of being associated with such overreaching.

Other similar proposals supported by the credit industry would result in the restriction of the use of the homestead exemption by household renters; a return to the pre-1978 state of the law that required — for purposes of determining preferences — that debtors show that their creditors had "reasonable cause" to believe that the debtor was insolvent; in the overvaluation of consumer goods used as collateral to secure a debt; and the repeal of the provision of current law that a loan secured by exempt property consisting of household goods and personal articles, tools of the trade, and professionally prescribed health aids already owned by (and in the possession of) the debor is invalidated in bankruptcy. Most loans affected by this proposal are made by loan companies which use as collateral household goods that have a low resale value on the market but a high value to their owner. Normally, the loan company does not want the household goods. However, if the credit industry gets its way, the loan company will be able to threaten the debtor with loss of these goods as a means of persuading the debtor to reaffirm the debt.

While we object to all these proposals in their present form, we recognize that the 1978 Act is not perfect, and that there may well be defects in that law that adversely and unfairly affect creditors. While we suggest that substantive changes must await resolution of the Northern Pipeline problem, we stand ready to work with this subcommittee to develop proposals that will improve current bankruptcy laws to the benefit of both creditors and debtors.

In that connection, we would be remiss if did not point out the problem now pending before the Supreme Court in National Labor Relations Board, et al. v. Bildisco and Bildisco, Debtor-In-Possession, et al., No. 82-818, petitions for certiorari granted January 11, 1983. The questions presented in that case are as follows:

> 1. Whether a bankruptcy court, in reorganization proceedings under Chapter 11 of the Bankruptcy Code, 11 U.S.C. (Supp. V) 1101 et seq., may authorize a debtor-in-possession to reject a collective bargaining agreement without a threshold showing that the business is likely to fail unless the agreement is rejected.
>
> 2. Whether the National Labor Relations Board may properly find that a debtor-in-possession violated Section 8(a)(5) of the National Labor Relations Act, 29 U.S.C. 158(a)(5), by unilaterally changing the terms of a collective bargaining agreement during the period filing of a Chapter 11 petition and entry of a court order authorizing rejection of the agreement.

And as the Solicitor General stated in that petition for certiorari:

> This case raises significant and recurring questions concerning accommodation of the policies underlying two statutory schemes -- the National Labor Relations Act and the Bankruptcy Code. The decision of the court of appeals acknowledgely conflicts with decisions of the Second Circuit regarding the showing that must be made by a debtor-in-possession in order to justify rejection of a collective bargaining agreement during Chapter 11 reorganization proceedings. The standard for rejection fashioned by the court of appeals in this case gives insufficient weight to the important statutory policy in favor of collective bargaining. In addition, the court of appeals' holding that the Board is precluded from finding an unfair labor practice based on a debtor-in-possession's unilateral alteration of the terms of a collective bargaining agreement during the period between filing of a Chapter 11 petition and court approval of rejection of the agreement seriously and improperly interferes with the

> Board's enforcement of the NLRA. The recent dramatic increase in bankruptcy filings makes resolution of these questions particularly important.

In large part, the conflict in the courts of appeals results from a disagreement as to the effect of the 1978 bankruptcy law amendments on the interplay between that law and the national labor law. Where the legal questions are at bottom ones of policy — as the questions presented in the Bildisco case most certainly are — we believe that a legislative answer is to be preferred to a judicial answer. True to the position we have taken on the consumer bankruptcy issues discussed above, we nonetheless believe that consideration of this issue vital to collective bargaining should await the signing of a Northern Pipeline bill. At that time, it would be our hope that this subcommittee would, as part of its overall review of substantive bankruptcy issues, make it absolutely plain that bankruptcy is not a means of oveturning valid collective agreements.

AGRICULTURAL PRODUCE BAILMENT AMENDMENTS

Senator DOLE. Our next witness is Stuart Proctor, legislative director, American Farm Bureau. This is with reference to the elevator bankruptcy proposals, and I have noted that in your statement you suggest a couple of clarifications which I think probably should be made.

Again, I would suggest that since the matter has passed the Senate three times, you simply file your statement and we will read it carefully.

STATEMENT OF STUART E. PROCTOR, JR., ASSISTANT DIRECTOR, NATIONAL AFFAIRS DIVISION OF THE AMERICAN FARM BUREAU FEDERATION

Mr. PROCTOR. I would like to point out one fact. This is the first day for the PIK program announced by the President.

Under this program, there will be situations where a farmer will have to take possession of a commodity stored in a grain elevator not stored in his county or State. The farmer will not be familiar with the management practices of that elevator. If the program is going to operate successfully, farmers must be assured that the property will be promptly returned to them in case of an elevator bankruptcy.

Senator DOLE. Are you making any progress in the House with the chairman over there?

Mr. PROCTOR. The chairman has appointed a subcommittee, with five members, on this question. We hope to work closely with this committee.

Senator DOLE. I guess the House Agriculture Committee has done that?

Mr. PROCTOR. Yes.

Senator DOLE. Unfortunately, they do not have jurisdiction in the House Agriculture Committee.

Mr. PROCTOR. No, they do not. They have jurisdiction over other solutions to the problem, which we do not support, but we are hopeful that they can be influential in encouraging the other committee to act promptly.

Senator DOLE. You made a reference to the PIK program. As you say, grain is going to be all over the place. It might be something that has not been considered by the chairman of the Judiciary Committee. So it might be one way to indicate to him the necessity of doing it rather quickly.

Again, the bill has passed the Senate on three occasions unanimously. We hope to pass it again this year with the clarifications you suggest. I think they should be made. We will do what we can in the Agriculture Committee and otherwise to expedite the process on the House side.

Mr. PROCTOR. One other point. We would like to see separate legislation on the elevator bankruptcy issue. You mentioned the Senate has passed it, and according to our records, it has passed four times.

Senator DOLE. Four? I only put out three press releases. [Laughter.]

Senator HEFLIN. However, if we get a compromise, you may want to ride that compromise.

Mr. PROCTOR. I guess it gets down to a question of legislative strategy. We would hope——

Senator HEFLIN. The word "coordination" includes legislative strategy.

Mr. PROCTOR. Very good.

Senator DOLE. We appreciate it very much. You have been an excellent witness. Your statement will be made part of the record.

Mr. PROCTOR. Thank you.

[The prepared statement of Mr. Proctor follows:]

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION REGARDING GRAIN ELEVATOR BANKRUPTCY

Presented by
Stuart E. Proctor, Jr., Assistant Director, National Affairs Division

January 24, 1983

I am Stuart E. Proctor, Jr., Assistant Director, National Affairs Division, American Farm Bureau Federation.

The Farm Bureau would like to thank Senator Dole for taking a leadership position in the effort to amend the bankruptcy code and to correct a situation which unfairly disadvantages grain producers throughout this country. Grain elevator bankruptcies are a serious problem facing farmers today. Farmers who have stored grain in commercial facilities and have maintained ownership of that grain find their property tied up if an elevator goes bankrupt. Often they are required to wait unreasonable lengths of time and incur unnecessary expenses. Only after the courts have resolved secured creditor claims is the producers' personal property returned to them. This poses an undue hardship, particularly when the stored products represent a major portion of grain farmers' marketable assets. The problem is becoming increasingly critical as farmers suffer their third consecutive year of depressed income.

Legislative action on this issue began early in the 97th Congress. In an eight state region in the Midwest, 38 bankruptcies occurred from January 1, 1981, to May 31, 1982. Based on a sample of those bankrupt-cies, claims averaged $725,000 per case and losses averaged 29 percent of the original claim. Therefore, while Congress has debated elevator bankruptcy legislation, millions of dollars of farmers operating capital have been effectively tied up in bankruptcy proceedings.

These statistics indicate the need for immediate legislative action. It is also important to note that producer sign-up for the payment-in-kind (PIK) program or "crop-swap" program, announced by President Reagan at the Farm Bureau Annual Convention in Dallas, begins today. Under provisions of this program, farmers may be given ownership to grain stored in elevators located in counties and states far removed from their farms. Under such conditions a producer will not be familiar with the management practices of the elevator operator. If the PIK program is to operate successfully, farmers must have confidence in the elevator in which their products are stored. They must be assured that there are legal mechanisms which will prevent unfair confiscation of their personal property in any case of elevator bankruptcy, and that they will obtain prompt release of their commodities once they prove ownership.

In view of the immediate need for legislative action on this problem we encourage you to pursue separate legislation for elevator bankruptcies. The passage of elevator bankruptcy bills in the 97th Congress on four separate occasions indicates recognition of the need for this legislation in the Senate. We encourage the Senate to again pass separate legislation in the 98th Congress.

Prompt passage of legislation to amend the bankruptcy laws will also pre-empt further consideration of the federal grain elevator insurance proposal which has received some discussion in the Senate and in the House. Farm Bureau is opposed to this legislation because:

-- Government action and involvement are not the panacea for all our problems. We advocate a reduction in the role of government in personal and business decisions rather than an increase;

-- It may encourage unsound management decisions by elevator operators and careless marketing decisions by farmers. This will only aggravate the problem rather than lead to a solution. State or federal legislation cannot substitute for wise business decisions or honesty;

-- Most grain producers do not want this degree of protection. They do not expect special treatment in the event of a bankruptcy; they only ask for relief from an unfair situation which allows their property to be considered as part of the assets of a bankrupt elevator; and

-- The cost of such a program should not exceed the claims for actual losses sustained by farmers in elevator bankruptcies. Yet many people in the grain industry suggest that administrative costs may exceed annual claims several times over.

Farm Bureau recognizes that a periodic review and update of regulations by state and federal agencies controlling the operation of elevator/warehouses is needed. In the last two years, USDA has acted to fulfill this responsibility by: appointing a Grain Elevator Task Force; appointing a React Committee for oversight review; modifying regulations to require an annual audited financial statement, and increasing the minimum net assets (from $10,000 to $25,000) and bonding requirements.

Another solution to the problem is to assist farmers in improving management decisions concerning storage of their commodities. Farm Bureau and other agricultural organizations have conducted various activities to help farmers adopt sound business practices and use good judgment in marketing their grain. Farm Bureau has: conducted seminars and distributed pamphlets explaining the reasons why elevators fail; identified danger signals which may give indications of an elevator's poor financial condition; and, listed ways to minimize financial exposure when storing grain. In view of USDA's actions to improve regulations and the actions by farm groups to help producers make sound management decisions, we feel that it is now time for legislative action to further correct this problem.

In our attempts to encourage Congress to pass legislation we have consistently asked that the following provisions be included:

-- Establish a reasonable statutory timetable for distributing the grain assets to holders of warehouse receipts;

-- Establish a temporary statutory lien for farmers who have sold but have not received payment for grain;

-- Elevate a holder of warehouse receipts to "secured creditor" position;

-- Legitimize a holder of warehouse receipts and scale tickets as evidence of ownership of grain; and

-- Prohibit the deduction of court or trustee expenses except those directly involved in the liquidation and distribution of grain assets back to farmer-owners.

We believe that these provisions will address the major obstacles, permitting grain elevator bankruptcies to be settled quickly. These obstacles include: (1) while the current bankruptcy laws contain provisions to expedite abandonment, the courts are not mandated to act quickly; (2) shortages which exist after warehouse receipt holders receive their grain become claims which are paid from funds designated for general creditors; (3) storage charges which accrue during settlement of the bankruptcy become assets of the trustee; and (4) high attorney fees discourage prompt action.

We supported Senator Dole's bill, S. 3037, introduced in the 97th Congress. However, there were two potential problem areas with that legislation which need further study. The first concerns the reclamation provision in Section 106. The way the bill was written, the provision could have been interpreted in one of three ways:

(1) Producers who have delivered grain but not received payment could demand payment at the expense of those with storage obligations;

(2) Producers who have not received payment would share the grain

on a pro rata basis with holders with storage obligations; and,

(3) Those with storage obligations would be paid first and those who had not received payment would be paid from remaining company assets.

We favor clarification in favor of the third possibility.

A second problem could have been created because the bill did not require that the grain be sold and the proceeds, rather than the grain itself, distributed to producers. The sale of grain was specified in previous bills to expedite the distribution to warehouse receipt holders and to hold down settlement costs. We encourage the reinstatement of that provision in any future bill.

After consideration of these two problems we encourage the reintroduction of S. 3037.

Senator Dole, again we thank you for the leadership position you have taken in the passage of elevator bankruptcy legislation. We are anxious to provide whatever help is necessary to assist you in your efforts to correct the current hardship which is being placed on agricultural producers.

REPURCHASE AGREEMENTS CODE AMENDMENTS

Senator **Dole**. We move to the Repurchase Agreement Code Amendments. We have Mr. Sternlight and Mr. Strauss.

STATEMENT OF PETER STERNLIGHT, EXECUTIVE VICE PRESIDENT, ACCOMPANIED BY DON RINGSMUTH, ASSISTANT GENERAL COUNSEL, FEDERAL RESERVE BANK OF NEW YORK; AND THOMAS W. STRAUSS, CHAIRMAN, GOVERNMENT AND FEDERAL AGENCY SECURITIES DIVISION, ON BEHALF OF THE PUBLIC SECURITIES ASSOCIATION

Senator **Dole**. As I recall, that is another noncontroversial area, so if you could briefly summarize your statements, they will be made part of the record.

Mr. **Sternlight**. Thank you, Mr. Chairman. I am Peter Sternlight. I have with me Don Ringsmuth, assistant general counsel at the bank. The committee has my prepared statement for the record. I would also request that the record include Chairman Volcker's letter to you of January 20, which is in support of these proposals related to repurchase agreements.

[Letter follows:]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

January 20, 1983

The Honorable Robert J. Dole
Chairman
Subcommittee on Courts
Committee on the Judiciary
United States Senate
Washington, D.C. 20510

Dear Chairman Dole:

I wrote to you on September 29 and December 13 of last year concerning certain proposed technical amendments to the Bankruptcy Reform Act of 1978 ("Code") that would stabilize the market for repurchase agreements ("repos"). I am writing to reiterate the Board's support for legislation that would exempt repurchase agreements from the automatic stay imposed by the Code. This exemption would ensure that parties holding securities subject to repurchase agreements with entities that are bankrupt could liquidate those securities and protect themselves from the risks of capital loss and illiquidity.

A court decision in the bankruptcy case of Lombard-Wall, a government securities dealer, has cast some doubt on the ability of repo participants to liquidate the securities that they hold subject to the agreement. The decision casts doubt on the liquidity and safety of repo agreements because the holder is subject both to unexpected illiquidity and risk of capital loss should unfavorable interest rate changes occur. The failure of a major market participant and the inability of other parties to liquidate their investment promptly could ripple outward through the securities market and cause an otherwise isolated problem to spread to other financial markets. Further, if the repo market were to become less attractive, its usefulness as an instrument of monetary policy would decline. For these two major reasons, the Board recognizes the importance of assuring proper functioning of the repo market.

The Board believes that a legislative solution of this problem is the best method of clarifying the law and avoiding possible structural problems in the financial markets. The proposed amendments would resolve this potential problem by exempting repos from the automatic stay in bankruptcy, thus providing repos with the same legal treatment as market participants believed they had prior to the Lombard-Wall decision. The amendments are drawn narrowly, so as to protect the markets and transactions that are large enough to create system-wide problems if disrupted, without undermining the structure of existing bankruptcy law. They extend to repurchase agreements the protections already granted to dealers in equity securities by the 1981 technical amendments to the Code enacted last July.

The Board requests that Congress enact the proposed amendments in order to diminish any potential problem for the stability of the nation's financial markets and to preserve repurchase agreements as an effective tool of monetary policy.

Sincerely,

Paul A Volcker

Mr. STERNLIGHT. My background, just a word on that. I have been at the Fed's trading desk since the 1960's, except for 2 years at Treasury working on debt management. For the last 3 years I have been manager of the System Account for Domestic Open Market Operations, which involves carrying out open market operations in support of monetary policy.

We view the repurchase agreement as a highly important part of the financial markets. First of all, it is used by the Fed. The bulk of our operations are short term to meet temporary needs for reserves or to counter temporary excesses of reserves.

Last year, we executed about $180 billion of repurchase agreements, and $142 billion of reverse repurchase agreements. We also executed $90 billion of repos for foreign official accounts in the U.S. Government securities market.

Repos are used heavily by dealers in Government securities in their day-to-day financing and in maintaining liquid markets in Treasury issues. Dealers play a major role as underwriters of Treasury issues.

Typically, the primary dealer community takes down 35 to 75 percent of the issue and remarkets it to other investors. They also take on Treasury issues in the course of making active secondary markets. That market trades about $30 billion a day.

Finally, many other financial markets participants use repos as a means to adjust liquidity, investing funds they may have available on short notice, or raising funds for a short period by the temporary sale of securities.

The common element in all these extensive uses of repo agreements is liquidity. Without that characteristic, the repurchase agreement would not serve the function that it now does. As you know, recent developments have threatened the liquidity of the market—namely, by raising the possibility that the automatic stay provisions of the Bankruptcy Code may be applied to an investor's holdings of securities under a repo. A holder who would not be able to meet his contract at maturity would clearly have his liquidity impaired.

This possibility has raised uncertainties among repo market participants, and has caused some to curtail their operations or even withdraw entirely from the market. The total effect is not yet severe for the overall market, but has the potential for becoming so.

The Federal Reserve collects data on repos and reverse repos from 38 dealers, and if you look at the statistics for last year, you can see when some of the market events occurred, like the failures of Drysdale Securities, and Lombard-Wall. There was an impact that was noticeable in the level of repurchase activity.

The total volume of repos did recover in the final months last year, but I think this was more a reflection of increased dealer financing needs because Treasury borrowing was so heavy, rather than a significant abatement of concern about repos.

Meantime, the cost of repos was rising relative to some other money market rates, such as the Federal funds rate, so that the greater repo financing that did come about late last year was not forthcoming readily in the market.

It may well be, too, that many participants have held off from changing their investment techniques in expectation that the Congress will soon resolve the uncertainties surrounding that instrument. I think without such action, we could see an accelerated and more severe overall impact.

What would be the consequences of a more severe impact on the repo market——

Senator DOLE. I hate to interrupt you, but I would like you to summarize.

Mr. STERNLIGHT. Let me say briefly that the consequences would be an impaired ability of the Fed to conduct its open market operations. If we had to use outright transactions, buying and selling huge amounts outright rather than under repo, there would be greater volatility of interest rates and a tendency to higher interest rates. There would also be an impaired ability of dealers to underwrite the Treasury and that would tend to raise interest rates. Finally, there would be reduced flexibility for many other users of the repo market.

Mr. Chairman, if the costs of adopting these changes that are proposed were appreciable, it would be tempting to wait and see whether the more severe effects on the repo market would emerge, but it seems to us a remedy is fairly simple, and we advocate that simple remedy.

Senator DOLE. As I understand it, we did include that provision in the last draft of the bill we had ready in the previous Congress, and I do not believe there is any opposition to that. I think that is something we can move on.

Mr. STERNLIGHT. I am not aware of any opposition.

Senator HEFLIN. If I understood it more, I might be opposed.

Senator DOLE. We have had it checked by experts, who support it.

We will make your statement a part of the record, as well as your summary.

Mr. Strauss?

Mr. STRAUSS. Mr. Chairman, my name is Thomas W. Strauss, testifying for the Public Securities Association. I will try to make my remarks brief and summarize my prepared statement.

We appreciate your inviting the PSA to testify regarding the proposed amendments to clarify the status of repurchase agreements, better known as repos, under the Bankruptcy Code.

PSA is a national trade association representing 300 banks and brokers and dealers who underwrite and sell U.S. Government and Federal agency securities.

Mr. Sternlight has already described the problem in the repo market brought about by the Lombard-Wall bankruptcy proceeding and related events.

I am here to tell you on behalf of the financial community that the problem is as serious as Mr. Sternlight described, and I am here to confirm that the PSA and virtually the entire financial industry, including banks, State and local governments, and pension funds, have all come together on this occasion in strong support of the Fed's proposed bankruptcy amendments to deal with this problem.

Prior to the Lombard-Wall filing, and related events of last year, investors believed that they could immediately liquidate their repo transactions in the market and cut the risk of loss as soon as they received word of a dealer's insolvency.

Now, however, the Lombard-Wall proceeding has raised considerable uncertainty whether investors can in fact legally liquidate their repo transactions.

The bankruptcy judge found the repos in that case were to be treated as secured transactions, thus leaving in some doubt the power of the holder of the securities to sell them without being subject to the automatic stay and avoidance provisions of the Bankruptcy Code.

Before Lombard-Wall, investors thought it did not make any difference for the purposes of the code whether repos were considered secured transactions or purchases and sales or otherwise, because repos may be characterized as one of several types of transactions, for tax law, securities law, and many other purposes.

The Fed's proposed repo amendments would solve the problem for most repos. They would allow investors to liquidate the repos and sell the Government securities they have without being subject to the automatic stay and avoidance provision with certain exceptions.

This proposal builds on the legislation you passed last year for the liquidation of certain securities contracts and commodities contracts.

The Fed has testified that the repo market is of critical importance to U.S. capital markets. The market is enormous, running into hundreds of billions of dollars, and involves a broad range of dealers and banks.

First, as Mr. Sternlight stated, the Federal Reserve Board through its Federal Open Market Committee and the open market desk at the Federal Reserve Bank of New York uses the repo market as a tool to execute domestic monetary policy.

Second, government securities dealers regularly acquire funds in substantial amounts in the repo market, especially to underwrite their issues in U.S. Government securities.

Third, institutional investors invest funds totaling many billions of dollars in the repo market. These include mutual funds, savings and loans, savings banks, and myriads of others.

Mr. Chairman, we are now running two major risks pending the enactment of the Fed's proposed repo amendments.

Senator DOLE. You are really running three. [Laughter.]

Mr. STRAUSS. First, as Chairman Volcker has written you, we face the serious risk of market gridlock and other ripple effects that might seriously paralyze our securities and commodities markets should a large dealer go bankrupt with billions of dollars of outstanding obligations to investors and dealers, which in turn have billions of dollars of obligations outstanding to other investors and dealers.

[See letter following prepared statement of Mr. Strauss on p. 346.]

Mr. STRAUSS. Second, if institutional investors face continuing uncertainty in entering into repos, we cannot finance U.S. Government securities as much as at present, and that could have a serious impact on financing the Federal debt.

Even now we face the prospect of additional deficit financing. We may not know for some time the impact of Lombard-Wall and related events on the repo market. The current upswing in the government securities market has probably masked some of this impact. In addition, it appears that many participants are staying in the repo market on the assumption that corrective bankruptcy legislation will be passed in the near future. Nonetheless, there are indications that sharp changes may be pending.

PSA samplings indicate that major categories of repo investors, such as pension funds and State and local authorities, have already cut back substantially on repo investments since the middle of last year.

In sum, Mr. Chairman, the Fed and the financial industry have jointly come up with a responsible and workable legislative solution for a serious financial problem without cost to the taxpayer. We join the Fed in urging prompt passage of the repo bankruptcy legislation without delay.

Thank you for allowing us to testify today. We will be pleased to answer any questions.

Senator Dole. Senator Heflin has no questions, and I have no questions. Your entire statement has been made part of the record. If a question should develop, we will be in touch with your staff.

Thank you very much.

[Submissions of Messrs. Sternlight and Strauss follow:]

STATEMENT OF
PETER D. STERNLIGHT
EXECUTIVE VICE PRESIDENT
FEDERAL RESERVE BANK OF NEW YORK AND
MANAGER FOR DOMESTIC OPERATIONS
SYSTEM OPEN MARKET ACCOUNT

I am pleased to have this opportunity to state my views in support of legislation which would clarify the status of certain repurchase agreements under the Bankruptcy Code.

Based on my experience at the Federal Reserve's Open Market Trading Desk since the 1960's, for the past three and a half years as Manager of the System Account for Domestic Operations, I believe that repurchase agreements involving U. S. Treasury issues and some other money market instruments provide a highly important degree of liquidity and flexibility to the markets in those instruments. Recently, the liquidity of the market for repurchase agreements has been threatened by the possible application of the automatic stay provision of the Bankruptcy Code. Without the assurance of liquidity, investments in repurchase agreements lose an essential characteristic, and would not serve the vital function they now perform. Nor are satisfactory alternatives readily available. Purchases or sales of securities without an agreement for their return provide an alternative but only at the expense of substantial interest rate risk and possible disruptive effects on interest rates in general. I therefore believe that there is a need for clarifying the status of the repurchase agreement through the proposed legislation.

There should be no question of the importance of the repurchase agreement in our Nation's financial markets. The Federal Reserve uses the instrument frequently and in great volume for implementing monetary policy. Last year, the Federal Reserve's Open Market Trading Desk executed about $180 billion of System repurchase agreements in the market to provide temporary injections of reserves, and about $42 billion of matched sale-purchase transactions--which are sometimes referred to as reverse repurchase agreements--for temporary absorptions of reserves from the market. That total of over $220 billion of transactions in Treasury and Federal agency issues and bankers' acceptances, to cope with temporary reserve needs or excesses, compares with about $12 billion of outright purchases or sales in the market during the year. We also executed about $90 billion of repurchase agreements in the market on behalf of foreign official accounts that had dollar balances to invest temporarily.

Federal Reserve open market operations would be impaired by an inefficient repurchase market and our ability to maintain an appropriate level of bank reserves from week to week would be diminished. I believe an attempt to use outright purchase and sale transactions to effect the reserve adjustments now made through repurchase agreements could prove disruptive to the securities markets, accentuating interest rate volatility while at the same time probably failing to achieve reserve growth objectives in the implementation of monetary policy. Federal Reserve operations to affect reserve availability on a single day through repos or reverse repos often come to $3 or $4 billion, and sometimes reach $5 billion or more. In contrast, purchases or sales of about $1 to $1 1/2 billion would be about as much as could ordinarily be done without risking market price and rate disruption. Likewise an attempt to meet the investment and liquidity objectives of foreign official accounts without the use of repurchase agreements could subject the securities markets to appreciable distortion and short-run rate volatility.

Repurchase agreements are also the most important way that dealers finance their substantial inventories of U. S. Government securities. The primary dealers typically underwrite a sizable portion of new Treasury issues--35 to 75 per cent--and rely heavily on temporary financing through repos pending resale of the issues to other investors. Clearly, an impairment of the repo market would make it less attractive for dealers to perform their very useful underwriting function, thus adding to Treasury interest costs.

Moreover, repurchase agreements are more than a financing instrument from the dealers' perspective. They are a major vehicle in the market making process, providing the means for creating hedges and arbitrages among various issues and thereby increasing liquidity. Through these transactions the dealer market adds to the close substitutability among Treasury issues, enhancing the attractiveness of the market for a variety of participants.

The instrument has also proven invaluable to a wide variety of institutional investors, both public and private. If those investors were deprived of the repo market, they would be less able to employ funds in a flexible and efficient manner, with adverse consequences for those particular market participants and for the economy at large.

As you know, the events of recent months--notably the failures of Drysdale and Lombard-Wall and especially the question of the application of the automatic stay in the Lombard-Wall bankruptcy--have generated uncertainty about the status of repurchase agreements under the Bankruptcy Code. This uncertainty has had a detrimental effect on the market. While the measurable effect is not yet severe, there is a clear potential for much greater impact as money market participants weigh the risks and benefits of continued use of repos. Our conversations with participants in the market and informal surveys we have conducted have underscored the fact that the market is disturbed by the implications of the treatment of repurchase agreements under the Bankruptcy Code. We have been informed that some participants have withdrawn from the market and virtually all are more apprehensive about their involvement and accordingly are more restrained in their willingness to participate.

Thus far the effects of the repo market uncertainties are more noticeable in expressions of attitude of market participants than in actual statistical evidence, but there are some statistics that also can be cited. The amount of outstanding repurchase agreements reported to the Federal Reserve by dealers showed some contraction in the periods immediately after the failures of Drysdale and Lombard-Wall, in May and August of 1982. Data for the final months of last year indicated some renewed expansion of outstanding repurchase agreements, but it should be noted that the level of repurchase activity is influenced by many factors, including the outlook for interest rates, the amount of Treasury debt being issued, dealer positions, and the liquidity needs of investors. With recent declines in interest rates and heavy issuance of Treasury debt, the dealers have had an incentive to participate more heavily in Treasury financing, thus adding to financing needs and repo volume. (See Chart I.)

At the same time, the evidence suggests that the additional repo financing late last year did not come easily, as repo costs have recently moved up in relation to other rates such as the Federal funds rate. Indeed, whereas the repo rate is normally significantly below the Federal funds rate, the two rates have come closer together since the Lombard-Wall case raised uncertainties about the status of repurchase agreements. In some recent weeks, the repo rate has even exceeded the Federal funds rate, although this may not be a lasting development. (See Chart II.) I should note, too, that dealers have used collateralized loans at banks to a greater extent in recent months than in some past periods--although this could have more to do with the type of inventory being financed than with the mix between bank loans and repos in financing inventories of Government securities. I would emphasize with respect to all of these statistical indications, however, that the period of observation is too short to draw firm conclusions at this point.

While the statistical evidence is not wholly conclusive, it does suggest strains and it leaves little room for complacency about the current and prospective effects of the repo market uncertainties. Markets are damaged by uncertainties. The damage may not be obvious for some time since markets often adjust over a period of time as participants make their individual decisions. A tendency for many participants to delay making fundamental changes in their behavior is not surprising under the current circumstances. The legislative proposal to exempt repos from the automatic stay provisions of the Bankruptcy Code has been widely publicized and many participants may be proceeding on the assumption that legislation will soon clear up the present uncertainties. If the expectations of favorable legislative action are disappointed, I would expect to see clearer evidence of deterioration of the market.

Leaving the present uncertainties in the Bankruptcy Code unattended, as it applies to repurchase agreements, is likely to result in widespread changes in the financial markets. Over time, the markets would seek to adapt, but the adjustment process could be a painful and costly one. Monetary policy would be implemented with greater difficulty. If the Federal Reserve is unable, or significantly less able, to use repurchase agreements because the market is less efficient, the Fed will have greater difficulty in achieving its monetary policy objectives.

Funding the national debt could also be more costly. If repurchase agreements remain under a cloud, the dealer market--a critical element in the process of financing the debt--would be handicapped.

More generally, a hobbling of the repo market could have broad rate effects throughout the financial markets, diminishing efficiency in the allocation of resources. Market participants would turn to less liquid forms of investment or more costly sources of funds--in either case tending to produce higher rates in the economy at large. Greater volatility of rates as a consequence of a diminished repo market could also add to average rate levels.

Last year's problems in the repo market were not entirely without beneficial effect. They did point up the need for market participants to be more alert to the credit risks they can incur. Some observers might argue that there would be no need to modify the Bankruptcy Code if each participant is careful enough to avoid counterparties who suffer bankruptcy. I believe that careful attention to credit should always be fostered but there is also a need to preserve the liquidity and safety of the repurchase agreement. The most skillful credit analysis will not entirely eliminate the possibility of being involved with a bankruptcy. The best way to preserve the immense value of the repurchase agreement is to modify the Bankruptcy Code so that participants can protect themselves by reliance on the readily determined value of the underlying securities.

Atts.

CHART I

FINANCING BY U.S. GOVERNMENT SECURITIES DEALERS
(TOTAL DEALER WEDNESDAY OUTSTANDING, IN BILLIONS OF DOLLARS)

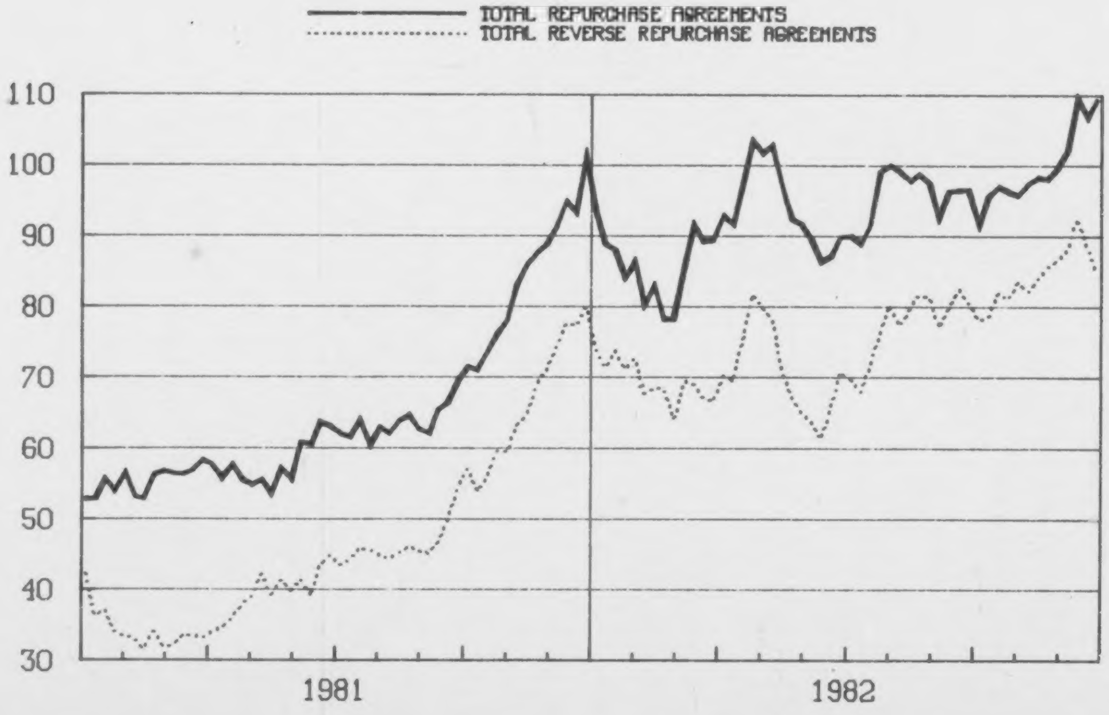
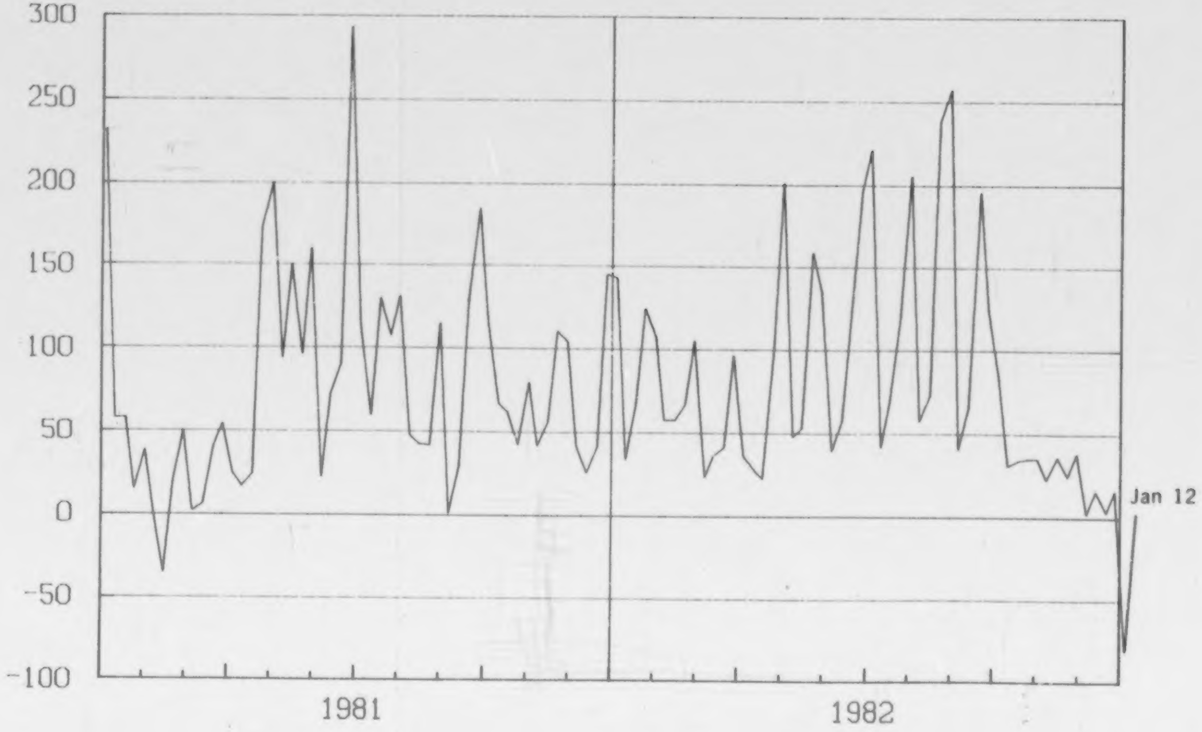


CHART II

FEDERAL FUNDS - DEALER RP RATE SPREAD

WEEKLY DATA, BASIS POINTS



Subtitle ___ -- Amendments Regarding Repurchase Agreements

SEC. ___ Section 101 of title 11, United States Code, is amended --

(a) by redesignating paragraphs (35), (36), (37), (38), (39), (40), and (41), as paragraphs (37), (38), (39), (40), (41), (42), and (43), respectively, and

(b) by inserting after paragraph (34) the following new paragraph:

"(35) 'repo participant' means any entity that, on any day during the period beginning 90 days before the date of the filing of the petition, has or has had one or more outstanding repurchase agreements with the debtor with an aggregate repurchase price of $1,000,000 or more;"

(c) by inserting after paragraph (35) the following new paragraph:

"(36) 'repurchase agreement' (which definition also applies to a reverse repurchase agreement) means any agreement, including related terms, which provides for the transfer of certificates of deposit, eligible bankers' acceptances, or securities that are direct obligations of, or that are fully guaranteed as to principal and interest by, the United States or any agency of the United States against the transfer of funds by the transferee of such certificates of deposit, eligible bankers' acceptances, or securities with a simultaneous agreement by such transferee to transfer to the transferor thereof certificates of deposit, eligible bankers' acceptances, or securities as described above, at a date certain within one year after such transfers or on demand, against the transfer of funds;"

SEC. ___ Section 362(b) of title 11, United States Code, is amended --

(a) by redesignating paragraphs (7) and (8) as paragraphs (8) and (9), respectively, and

(b) by inserting after paragraph (6) the following new paragraph:

"(7) under subsection (a) of this section, of the setoff by a repo participant, of any mutual debt and claim under or in connection with repurchase agreements that constitutes the setoff of a claim against the debtor for a margin payment, as defined in section 741(5) or 761(15) of this title, or settlement payment, as defined in section 741(8) of this title, arising out of repurchase agreements against cash, securities, or other property held by or due from such repo participant to margin, guarantee, secure or settle repurchase agreements;"

SEC. ___ Section 546 of title 11, United States Code, is amended by inserting after paragraph (d) the following new paragraph:

"(e) Notwithstanding sections 544, 545, 547, 548(a)(2), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment, as defined in section 741(5) or 761(15) of this title, or settlement payment, as defined in section 741(8) of this title, made by or to a repo participant, in connection with a repurchase agreement and that is made before the commencement of the case, except under section 548(a)(1) of this title."

SEC. ___ Section 548(d)(2) of title 11, United States Code, is amended by inserting after paragraph (B) the following new paragraph:

"(C) a repo participant that receives a margin payment, as defined in section 741(5) or 761(15) of this title, or settlement payment, as defined in section 741(8) of this title, in connection with a repurchase agreement, takes for value to the extent of such payment."

SEC. ___ Section 553(b)(1) of title 11, United States Code, is amended by inserting ", 362(b)(7)," after "362(b)(6)".

SEC. ___ (a) Chapter 5 of title 11, United States Code, is amended by adding at the end thereof the following new section:

"§ 557. Contractual right to liquidate a repurchase agreement

The exercise of a contractual right of a repo participant to cause the liquidation of a repurchase agreement because of a condition of the kind specified in section 365(e)(1) of this title shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title, unless, where the debtor is a stockbroker or securities clearing agency, such order is authorized under the provisions of the Securities Investor Protection Act of 1970 (15 U.S.C. 78aaa et seq.) or any statute administered by the Securities and Exchange Commission. In the event that a repo participant liquidates one or more repurchase agreements with a debtor and under the terms of one or more such agreements has agreed to deliver assets subject to repurchase agreements to the debtor, any excess of the market prices received on liquidation of such assets (or if any such assets are not disposed of on the date of liquidation of such repurchase agreements, at the prices available at the time of liquidation of such repurchase agreements from a generally recognized source or the most recent closing bid quotation from such a source) over the sum of the stated repurchase prices and all expenses in connection with the liquidation of such repurchase agreements shall be deemed property of the estate, subject to the available rights of setoff. As used in this section, the term 'contractual right' includes a right set forth in a rule or bylaw, applicable to each party to the repurchase agreement, of a national securities exchange, a national securities association, or a securities clearing agency, and a right, whether or not evidenced in writing, arising under common law, under law merchant or by reason of normal business practice."

(b) The analysis of sections for chapter 5 of title 11, United States Code, is amended by adding at the end thereof the following new item:

"557. Contractual right to liquidate a repurchase agreement."

SEC. ___ The amendments made by this Subtitle shall become effective upon the date of enactment, provided that they shall apply only to cases commenced on or after the date of enactment.

Section-by-Section Analysis

Definitions

Section ____ makes conforming redesignations of subsequent definitions.

Section ____ provides a new definition for "repo participant" in section 101. "Repo participant" includes any entity that, on any day during the period beginning 90 days before the date of the filing of the petition, has one or more outstanding repurchase agreements with the debtor with an aggregate repurchase price of $1,000,000 or more. The 90 day period is based on the preference period set forth in section 547 of the Code. This definition is intended to include an entity acting for its own account or for the account of one or more other entities (whether as custodian, trustee, fiduciary, agent or in any other capacity). It is also intended to include an entity, acting for its own account or for one or more other entities, or both for itself and for another or other entities, that may have entered into one or more repurchase agreements with a single debtor which may each involve a stated repurchase price of less than $1,000,000, but which would have an aggregate stated repurchase price of $1,000,000 or more.

It is not intended by the provisions of this definition to affect the status of agreements involving an aggregate repurchase price of less than $1,000,000 under other provisions of the Code, such as those, for example, protecting securities contracts and forward contracts.

Section ____ provides a new definition for "repurchase agreement" in section 101. "Repurchase agreement" means any agreement which provides for the transfer of certificates of deposit, eligible bankers' acceptances, or securities that are direct obligations of, or that are fully guaranteed as to principal and interest by, the United States or any agency of the United States against the transfer of funds by the transferee of such certificates of deposit, eligible bankers' acceptances, or securities with a simultaneous agreement by such transferee to transfer to the transferor thereof certificates of deposit, eligible bankers' acceptances, or securities as described above, at a date certain within one year after such transfers or on demand, against the transfer of funds. This definition also applies to a reverse repurchase agreement. It also covers any related terms in a repurchase agreement (such as mark-to-market provisions). For purposes of this definition an "eligible bankers' acceptance" is either (i) an acceptance by any institution of a draft or bill of exchange drawn on itself which, if drawn on a member bank, would be eligible for acceptance under the criteria established in subparagraph (A) of the seventh paragraph of section 13 of the Federal Reserve Act, 12 U.S.C. § 372, or (ii) an acceptance which, on the date the repurchase agreement is entered into, is eligible for purchase under the rules of the Federal Open Market Committee.

While repurchase agreements may be open to various kinds of characterizations and are characterized in market practice under various legal relationships, it is intended by this section that any agreement that meets the terms of the definition of repurchase agreement shall receive the treatment in bankruptcy that is provided for in this subtitle.

The definition does not require (or prevent) the original and reverse transfers to be provided for in separate agreements or confirmations. A repurchase agreement may be either written or oral.

In accordance with market practice, some repurchase agreements permit certain substitutions of the assets subject to the repurchase agreement. Accordingly, under agreements covered by this definition, the transferor may make certain substitutions of assets, but only assets of at least equal market value to those originally transferred and falling within the same one of the three enumerated categories (i.e., certificates of deposit, eligible bankers' acceptances, or U.S. government and Federal agency issued or guaranteed securities). The transferee may return only assets that are the same in all material respects as those last transferred or substituted by the transferor.

Repurchase agreements for only certificates of deposit, eligible bankers' acceptances, and U.S. government and Federal agency issued or guaranteed obligations are afforded the amendment's treatment under the Code. As provided in section 102(5) of title 11, United States Code, the enumeration of the underlying types of property in the alternative is not exclusive; a repurchase agreement can involve the transfer or re-transfer of a combination of the enumerated kinds of property. It is not intended by the enumeration in this definition to affect in any way the status of repurchase agreements for any item, whether or not covered by the definition, under other provisions of the Code, such as those, for example, protecting securities contracts and forward contracts.

In particular, a repurchase agreement as defined in this subtitle, insofar as it applies to a security, would continue to be a securities contract as defined in the Code and thus also would be subject to the Code provisions pertaining to securities contracts. Similarly, insofar as a repurchase agreement as defined in this subtitle applies to a commodity, it would continue to be a forward contract for purposes of the Code and would be subject to the forward contract provisions of the Code.

The reference to "direct obligations of, or that are fully guaranteed as to principal and interest by, the United States or any agency of the United States" is based on section 14(b) of the Federal Reserve Act, 12 U.S.C. § 355, and is intended to include all obligations of, or that are fully guaranteed as to principal and interest by, any entity whose obligations are determined by the Board of Governors of the Federal Reserve System to be eligible for purchase by Federal Reserve banks under the similar language of section 14(b) of the Federal Reserve Act.

Automatic Stay

Section ____ makes conforming redesignations of subsequent paragraphs.

Section ____ is intended to clarify that, despite the automatic stay of section 362(a), a repo participant may set off a claim for a margin or settlement payment arising out of repurchase agreements against the repo participant's obligations to the debtor in respect of cash, securities or other property that the repo participant is holding, or that is due to the debtor, to margin, guarantee, secure or settle repurchase agreements, notwithstanding the bankruptcy of the party for whose account such cash, securities, or property is held. This provision is essentially parallel to the one in existing Code section 362(b)(6).

This section refers to settlement payments as defined in section 741(8). It is intended for purposes of this section and the other provisions added by this subtitle that any amount paid or payable with respect to any interest, dividend or other distribution in respect of the certificate of deposit, eligible bankers' acceptance, or security that is the subject of the repurchase agreement and any amount paid or payable with respect to any interest, rebate or other fee in respect of the repurchase agreement, regardless of whether the amount is paid or payable on a settlement date or a different date, constitute a settlement payment within the meaning of that term as defined in section 741(8). Such items serve the same function as other, more conventional types of settlement payment and are commonly used in the securities trade. This assures consistency of treatment, since it is understood that similar amounts paid or payable with respect to securities contracts likewise come within the definition of settlement payment as defined in section 741(8) for purposes of the Code provisions relating to securities contracts.

Avoiding Powers

Section ___ creates a new subsection to section 546 which, together with provisions of section 548, clarifies that a trustee is prohibited from avoiding a transfer that is a margin payment or settlement payment made by or to a repo participant in connection with a repurchase agreement, except where the transfer was made with actual intent to hinder, delay or defraud other creditors and the property transferred was not taken in good faith. This prohibition is parallel to the one in existing Code section 546(d).

Section ___ creates a new subsection to section 548(d)(2) to clarify that all margin or settlement payments made in connection with a repurchase agreement are taken for value to the full extent of such margin payments. This new provision is parallel to the one in existing Code section 548(d)(2)(B).

Setoffs

Section ___ makes a conforming change.

Protection for Liquidation of a Repurchase Agreement

Section ____ adds a new section to the end of Chapter 5 of title 11 to clarify that the exercise of a contractual right of a repo participant to cause the liquidation of a repurchase agreement, because of a condition of the kind specified in section 365(e)(1) of title 11, shall not be stayed, avoided or otherwise limited in any proceeding under title 11 by a court or administrative agency, unless, where the debtor is a stockbroker or securities clearing agency, such order is authorized under the provisions of the Securities Investor Protection Act of 1970 (15 U.S.C. 78aaa *et seq.*) or any statute administered by the Securities and Exchange Commission. This provision would confirm that the liquidation would terminate any right of the debtor's trustee to affirm an executory contract in respect of a repurchase agreement. The prompt liquidation of an insolvent's position is generally desirable to minimize the potentially massive losses and chain reaction of insolvencies that could occur if the market were to move sharply in the wrong direction. This provision is parallel to the one in existing Code section 555.

The amendment also contains an excess proceeds provision applicable in the event that a repo participant liquidates one or more repurchase agreements with a debtor and under the terms of one or more such agreements has agreed to deliver assets subject to such agreement or agreements to the debtor.

In such an event any excess of the market prices received on liquidation of such assets (or if any such assets are not disposed of on the date of liquidation of such repurchase agreements, at the prices available at the time of liquidation of such repurchase agreements from a generally recognized source or the most recent closing bid quotation from such a source) over the sum of the stated repurchase prices and all expenses (including such items as brokerage fees, bank charges or fees for legal services) in connection with the liquidation of such repurchase agreements shall be deemed property of the estate, subject to the available rights of setoff. It is intended that the rights of setoff and other remedies permitted elsewhere in the Bankruptcy Code and under other law are not to be limited by this provision.

The new section includes a definition of the term "contractual right" in respect of repurchase agreements to make explicit that this term includes rights arising under common law, under law merchant or by reason of normal business practice whether or not evidenced in writing, as well as a right set forth in a rule or bylaw, of a national securities exchange, a national securities association, or a securities clearing agency that is applicable to each party to the repurchase agreement. It is understood and intended that such a rule or bylaw would be applicable to each party to the repurchase agreement only if each of them is a member of the exchange, association or agency promulgating the rule or bylaw or has agreed to be bound by such rule or bylaw.

Section ____ makes a conforming change.

Effective Date

Section ___ provides that these amendments shall become effective on the date of enactment but shall not apply to cases commenced before the date of enactment.

STATEMENT REGARDING PROPOSED REPO AMENDMENTS TO THE BANKRUPTCY CODE

I. Introduction

Use of repurchase agreements (sometimes referred to herein as "repos")[1] has grown rapidly in recent years. Repos are now considered to be a principal means of financing the market for United States Government securities and money market instruments. Recently, however, a serious question has arisen whether the securities and commodities amendments to the Bankruptcy Code (the "Code"), enacted last year as Public Law 97-222, adequately cover the repo market. As a first step, the proposed amendments to the Code would address this question:

a. by providing new definitions of "repo participant" and "repurchase agreement" in section 101, and

b. by creating a new section at the end of Chapter 5 and making conforming amendments to sections 362(b), 546, 548(d)(2) and 553(b)(1) of the Code to ensure there is no question that repo participants are afforded the same treatment with respect to the stay and avoidance provisions of the Code in connection with repurchase agreements, as newly defined, which Public Law 97-222 explicitly provided stockbrokers, securities clearing agencies, commodity brokers and forward contract merchants in connection with securities contracts, commodity contracts and forward contracts.

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[1] A repo represents a transfer of a financial instrument -- often government securities -- by one party to another party for payment, with a simultaneous agreement by the second party to retransfer securities to the first party on demand or on a date certain against payment which reflects a rate of interest. A reverse repo is the mirror image of a repo, generally initiated by the party originally transferring the securities.

These amendments would take an important first step in resolving the recent uncertainty about whether the provisions of Public Law 97-222 adequately cover the repo market. This uncertainty largely stems from litigation in the Lombard-Wall case, as described below, and has introduced considerable confusion in the use of repo transactions in financial markets. The current Congressional review of other major problem areas in the Code presents an immediate opportunity to eliminate this confusion.

These amendments are offered as an emergency measure to deal with the effect of the present uncertainty on the repo market only in respect of U.S. Government and agency obligations, certificates of deposit, and eligible bankers' acceptances.

II. Description of the Repo Market

As indicated above, repo transactions provide one of the major mechanisms for limited-term investment involving all U.S. Government and agency securities, mortgage-related instruments, commodities and all money market instruments (e.g., certificates of deposit, bankers' acceptances and commercial paper).

The volume of repo transactions is very large. The 36 members of the Association of Primary Dealers in U.S. Government Securities (the "Primary Dealers") alone engage in repo transactions amounting to about $25 billion to $30 billion each day. It is difficult to determine the total size of the repo market, but one can safely estimate that the aggregate daily amount of repo transactions amounts to several hundred billion dollars. This should come as little surprise, since the financial assets that are the subject of repos include a substantial part of the approximately trillion dollar U.S. public debt.

The repo market serves a crucial function for both parties to the repo transaction. The country's major institutional and fiduciary investors make heavy use of repos. For these investors, including such entities as state and local governments, public and private pension funds, money market and other mutual funds, banks, thrift institutions, and large corporations, repos have become a vital tool of cash management.

The repo is particularly well-suited to the needs of these investors. Receipts of taxes and the proceeds of bond issues in the case of state and local goverments, cash flows from corporate operations, and liquidity needs of thrift institutions and money market funds often fail to coincide with the planned expenditures of such funds, thereby creating the need for such entities to invest idle funds for short periods in as risk-free a manner as possible.

Repos generate income for the supplier of funds while at the same time providing flexibility, since they can be arranged for periods which match the supplier's cash flow needs, including periods as short as one day. Few, if any, other investment vehicles have this feature. Government securities or other financial assets can be bought and held for short periods other than in repo transactions, but the transaction costs can be relatively high. Moreover, the possibility of capital loss due to market rate volatility or the risk of reinvestment at a lower rate of return significantly reduces the attractiveness of investment alternatives.

For the Primary Dealers in the government-related securities market, the repo market has become the principal means of financing their positions. Repos provide dealers with the financing that is essential for them to buy newly-issued government securities. Repos also enable other dealers to obtain these newly-issued securities from the Primary Dealers. If repo financing becomes unavailable or more costly due to adverse interpretations of the Code, the distribution system for newly-issued government securities and the federal government's ability to raise funds in a cost-effective manner will be adversely affected. This would in turn increase the cost of government borrowing and the level of interest rates generally.

Wide public and private sector participation is important to the reliable functioning of the repo markets and permits the U.S. Treasury and other federal agencies to finance the country's public debt at rates of interest lower than otherwise would be possible. Moreover, it provides additional incentive for foreign central banks and other foreign holders of U.S. dollar reserves to participate in financing the nation's public debt.

Just as important, the repo market plays an important role in the conduct of monetary policy. The Federal Open Market Committee, through the Trading Desk at the Federal Reserve Bank of New York (the "New York Fed"), makes extensive use of repos in regulating the supply of funds in the execution of monetary policy. Repos have become a highly flexible and effective short-term tool for the Federal Reserve System. The effectiveness of the repo market as a tool of monetary policy depends in turn upon broad-based public participation.

As indicated above, the efficient functioning of the repo market also facilitates substantial involvement by foreign central banks, monetary authorities, and international institutions in financing the U.S. public debt. The New York Fed maintains accounts for approximately 140 foreign central banks, monetary authorities, and international institutions. With such large international holdings of the dollar, it has become important to the orderly financing of the public debt that these institutions purchase U.S. Government securities. In 1979, for example, the dollar volume of investment activity for these foreign accounts alone at the New York Fed exceeded $1.4 trillion, most of which involved U.S. Government securities. A substantial amount of this activity was in repos.

Finally, the existence of an efficient repo market in U.S. Government securities enhances the attractiveness of the U.S. dollar as an international reserve currency. The dollar is the principal reserve currency in the world.

III. Repo Market in Jeopardy

The effective functioning of the repo market can only be assured if repo investors will be protected against open-ended market loss arising from the insolvency of a dealer or other counterparty in the repo market. The repo market is as complex as it is crucial. It is built upon transactions that are highly interrelated. A collapse of one institution involved in repo transactions could start a chain reaction, putting at risk hundreds of billions of dollars and threatening the solvency of many additional institutions.

Since the repo market is important to the health of the country's financial system, it is desirable that the Code be interpreted and implemented in a manner which protects that market without creating an unfair result for debtors. Similar concerns led to Public Law 97-222. Despite Public Law 97-222, investors in the repo market have in the last several months found themselves faced with considerable uncertainty about the treatment of repos in bankruptcy proceedings. The provisions of Public Law 97-222 are not believed adequately to protect liquidations of repos in the event of the insolvency of a dealer or other participant in the repo market, even though the principal objective of Public Law 97-222 was to prevent the insolvency of one commodities or securities firm from spreading to other firms and possibly threatening the stability of the affected market. H.R. Rep. No. 97-420, 97th Cong., 2nd Sess. 1 (1982).

The uncertainty was highlighted by the filing in the Bankruptcy Court in the Southern District of New York of a Chapter 11 bankruptcy petition by Lombard-Wall Inc. in August

1982.[2] A bench decision in the Lombard-Wall case held that the holder of securities subject to a repurchase agreement was subject to the automatic stay of the Code, and that this holder was precluded from closing out its position with the debtor without approval of the Court. Lombard-Wall Incorporated v. Columbus Bank & Trust Co. et al. (In re Lombard-Wall Incorporated), No. 82 B 11556, Bankr. Ct., S.D.N.Y., bench decision, September 16, 1982. This holding made clear the risks to the market created by the Code's stay and avoidance provisions and demonstrated that Public Law 97-222 is not sufficient in scope to protect the market from major dislocations caused by bankruptcy of market participants.

The Lombard-Wall proceedings and their extensive press coverage have had an adverse impact on the financial markets and undermined the primary purposes of Public Law 97-222 because the repo market is subject to the same ripple effect as other securities markets.[3]

Uncertainty as to the scope of coverage of Public Law 97-222 with respect to the repo market has already caused special problems for certain categories of investors. The U.S. Department of Housing and Urban Development has recently decided not to permit further investment in repos by Public Housing Authorities, Indian Housing Authorities and FHA-Approved Mortgagees for Multifamily Projects. Standard and Poor's has suspended rating of "structured municipal issues" (which permit investment of municipal bond or note proceeds in repurchase agreements) with government securities dealers not rated by

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[2] Some question about the legal status of repos in the bankruptcy context had also been raised earlier in 1982 with the collapse of Drysdale Government Securities Inc., even before the enactment of Public Law 97-222. Drysdale's failure has also had a wide impact on the repo market and in fact contributed to Lombard-Wall's problem.

[3] See Carrington, Securities in Lombard-Wall Case Termed Loan Collateral by a Bankruptcy Judge, Wall St. J., Sept. 20, 1982, at 10, col. 2.

Standard and Poor's because of the questions raised by the Lombard-Wall bankruptcy about the ability of a bond or note trustee to liquidate, in a timely manner, securities held under a repurchase agreement where the seller-repurchaser files for protection under the Code.

Open-ended mutual funds, particularly the money market funds, use repos on a short term basis to assist in managing their portfolios, to provide flexibility and to provide higher return with relative safety. As of October 31, 1982, money market funds held repo agreements totalling approximately $19.4 billion.

The recent focus on safety and liquidity of repos in the event of a bankruptcy filing by a participant to a repo has raised concerns about their use by the mutual fund industry in light of the regulatory standards under the Investment Company Act of 1940. On November 4, 1982, the Securities and Exchange Commission's Division of Investment Management, in a memorandum to Chairman Shad, indicated that it would revise a previous "no action" position regarding repos and require that investment company boards of directors, to the extent practicable, evaluate the creditworthiness of the brokers or dealers with which they propose to engage in repo transactions and that it would require that government securities money market funds which advertise that their portfolio securities are government guaranteed to disclose substantial investments in repos.

While these concerns are currently being addressed within the mutual fund industry, the only certain solution at this time appears to be the proposed amendments to the Bankruptcy Code, which assure protection to the repo market participant. If a bankruptcy filing does occur, the proposed legislation would protect the liquidity of a fund's repo with a debtor, and permit the fund to achieve its bargained-for contract rights.

Safety and the ability to specify term are the key elements of repos which make them attractive to funds. Both elements promote liquidity for funds. Money market funds, by their nature, are required to be highly liquid and are used by millions of investors on a daily basis for investment in and redemption of fund shares. The ability to redeem promptly, at net asset value, is crucial to the operation of these funds and the maintenance of investor confidence. The filing of a case under the Code by a government securities dealer, or other party which holds a repo with a fund, puts these key elements in some doubt. Although there is little likelihood that bankruptcies involving fund repos would occur with any frequency, the mere possibility, under present law, raises significant issues as to the safeguards and circumstances under which funds should utilize repos in their investment portfolios.

The proposed amendments to the Code, described below, will help assure that the objective of Public Law 97-222 to minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy (128 CONG. REC. H261 (daily ed. February 9, 1982) (statement of Rep. Edwards)) is carried out by expressly providing the repo market the same protection.

IV. Proposed Repo Amendments

The proposed amendments will take an important first step toward meeting the full objective of Public Law 97-222 by expressly providing that similar protections apply to the crucial portions of the repo market involving U.S. Government and agency obligations, certificates of deposit, and eligible bankers' acceptances. The structure of the proposed amendments is based upon the addition to the Code of new definitions of "repo participant" and "repurchase agreement" and the making of conforming changes in relevant provisions of the Code. The proposed amendments are intended to afford participants in the repo market the same treatment with respect to the stay and avoidance provisions of the Code that Public Law 97-222 explicitly provided stockbrokers, securities clearing agencies, commodity brokers and forward contract merchants in connection with securities contracts, commodity contracts and forward contracts.

The amendments would apply only to certain repurchase agreements, namely those involving certificates of deposit, eligible bankers' acceptances, or securities that are direct obligations of, or that are fully guaranteed as to principal and interest by, the United States or any agency of the United States. These amendments are not intended, however, to affect the status of repos involving securities or involving commodities as securities contracts, commodity contracts, or forward contracts, and their consequent eligibility for similar treatment under other provisions of the Code, such as the provisions giving protection to stockbrokers, securities clearing agencies, commodity brokers, and forward contract merchants for liquidation and setoff in respect of securities contracts, commodity contracts or forward contracts. In particular, a repurchase agreement as defined in the amendments, insofar as it applies to a security, would continue to be a securities contract as defined in the Code and thus also would be subject to the Code provisions pertaining to securities contracts. Similarly, insofar as a repurchase agreement as defined by the amendments applies to a commodity, it would continue to be a forward contract for purposes of the Code and would be subject to the Code provisions pertaining to forward contracts.

The section-by-section analysis following the proposed amendments describes their provisions in detail.

PREPARED STATEMENT OF THOMAS W. STRAUSS

INTRODUCTION

The Public Securities Association ("PSA") appreciates the opportunity to testify in support of corrective legislation which would clarify the status of repurchase agreements ("repos") under the Bankruptcy Code. PSA is the national trade association representing approximately 300 banks, dealers and brokers that underwrite, trade and sell U.S. government and federal agency securities. In addition, 35 of the 36 primary dealers in government securities, as recognized by the Federal Reserve, are PSA members.

We share the view of the Federal Reserve Board that adoption of legislation permitting the timely and effective liquidation of repos and their underlying obligations or securities is necessary to avoid the possibility of serious disruption in the repo market. Consequently, PSA strongly supports legislation like that proposed by the Federal Reserve Board to afford participants in the repo market the same protections with respect to the stay and avoidance provisions of the Bankruptcy Code that Public Law 97-222 explicitly provides stockbrokers, securities clearing agencies, commodity brokers, and forward contract merchants in connection with securities contracts, commodity contracts, and forward contracts. The current Congressional attention to other major problem areas in the Code offers an immediate opportunity to achieve prompt enactment of this proposal.

The events of the past eight months, particularly the failure of Drysdale Government Securities, Inc., and the reorganization of Lombard-Wall, Inc., have significantly altered the assumptions of many market participants concerning the level of risk inherent in repurchase transactions. In the Lombard-Wall proceeding, Bankruptcy Judge Edward T. Ryan (S.D.N.Y.) indicated in a September 16, 1982, bench ruling that certain repos involved in that case are to be treated for purposes of the Bankruptcy Code as "secured transactions." Such a characterization cast considerable doubt on what most participants in the repo market previously had assumed was the ability to liquidate a repo agreement not withstanding the bankruptcy of the other party.

The uncertainty which prevails as a result of these developments not only threatens the continued efficient functioning of the repo market, which is the largest capital market in the world, but also raises questions as to the continued effective operation of the markets for both U.S. government and municipal securities.

DEFINITION OF A REPO

A repo is technically an agreement which comprises two distinguishable acts, but is part of a single transaction. Securities, most often U.S. government and/or federal agency securities, are transferred by the first party (e.g., a securities dealer or dealer bank) to a second party (e.g., a customer) for payment, with a simultaneous agreement that the second party will retransfer the same or substituted securities on demand or a day certain, against a specified payment, including interest or its equivalent at a specified rate. A reverse repo is merely the mirror image of a repo transaction. In a reverse repo, securities are acquired by the first party with the simultaneous agreement of the second party to reacquire the same or substituted securities.

HISTORY AND DEVELOPMENT OF THE REPO MARKET

Repos were first used in the 1920's as a financing vehicle for interbank borrowing. In the 1950's, they began to be used as an alternative means of facilitating dealer financing. In 1969, Federal Reserve Regulation D was amended to specifically exempt U.S. government and federal agency securities subject to a repurchase agreement from reserve requirements. Since then the repo market has flourished.

The development of repos has proved to be advantageous to the financial markets. Participants in this market are provided with an instrument which offers combined characteristics of risk, maturity, flexibility, and liquidity not previously offered by other short-term money market instruments. Repos are typically backed by government securities or other money market instruments and are adaptable for a wider range of uses than most other financial instruments. Any person or firm may deal in repos, while participation in the federal funds market is limited to commercial banks, mutual savings banks, savings and loan asociations, and federal agencies. Repos can be arranged for any maturity, while certificates of deposit (an alternate source of funds to banks) usually are not issued for less than 30 days, and commercial paper is seldom written for a period as brief as a day or two.

By providing a mechanism through which large supplies of liquid balances are loaned daily, the repo market has improved the ability of the economy to direct short-term funds into areas of greatest demand. Thus, repos enhance the efficient allocation of resources in the capital markets.

In addition, repos have increased the liquidity of the instruments used as collateral, including longer term government and agency obligations. The securities become more liquid since they may be used to raise funds on short notice without incurring the risk of capital loss that might occur if an outright sale were the sole option.

Finally, repos facilitate arbitrage between financial instruments, as well as provide a straightforward source of cash or investment outlet for short-term funds. For example, repos have broadened the sources of securities available to traders active in short selling. In addition, repos can be used during a period of rising interest rates to supplement the yield on portfolios by allowing investors to invest in higher-yielding instruments without having to sell outright and take a capital loss on the securities in the portfolio.

THE IMPORTANCE OF THE REPO MARKET

The repo market is of critical importance to the U.S. capital market system. The importance of this market is due not only to its enormous size but to the wide range of institutional participants which derive benefits from the use of repos.

First, and most importantly, the Federal Reserve Board, through its Federal Open Market Committee and the Open Market Desk at the Federal Reserve Bank of New York, uses the repo market as a tool to execute domestic monetary policy. The Fed typically uses repos either to drain reserves temporarily (by selling securities) or to inject reserves temporarily (by buying securities) into the banking system. The Fed also uses repos to invest the funds of about 140 foreign central banks for which it provides a variety of banking services. In 1982, the New York Fed reports that its Domestic Trading Desk entered into $100 billion of repo transactions for Federal Reserve monetary policy purposes and $90 billion on behalf of official foreign accounts.

Second, government securities dealers regularly acquire funds in substantial amounts in the repo market to finance their new issue underwriting and existing inventory positions, especially in U.S. government securities. It is estimated that the "primary dealers" of U.S. government securities (consisting of 12 dealer banks and 24 securities firms reporting to the Federal Reserve Board) engage in repo transactions amounting to between $25-30 billion on any given day.

Third, institutional investors correspondingly invest funds (either for their own accounts or on behalf of others in their fiduciary capacity) totaling many billions of dollars in the repo market. These investors include mutual funds, pension funds, state and local governments, commercial banks, thrifts, corporations, and other securities dealers which have used the repo market in this manner to invest surplus cash. The ultimate beneficiaries of these investments include tens of millions of pension fund participants, money market fund shareholders, and state and local taxpayers all across the country.

Fourth, both institutional investors and government securities dealers are able to provide securities in the repo market for a limited period of time, while continuing to realize a yield on their original investment. This is generally accomplished by investment of the funds received in an alternative money market instrument bearing an interest rate higher than the rate on the repo, thus realizing an arbitrage spread profit.

Fifth, both institutional investors and government securities dealers use the repo market to acquire securities from other participants in the market for a limited period of time. These transactions enable a participant to make delivery of securities already sold but not immediately available, *e.g.*, to cover a short position.

THREATS TO THE REPO MARKET

The effectiveness of the repo market to serve all of these functions in the money market depends upon a high level of certainty about the ability of the various repo participants to close out repo transactions in the event of insolvency of the other party to the transaction, and to assure that repo transaction payments previously received from that party will not be reclaimed by the trustee under the Bankruptcy Code. The rapid growth in activity in the repo market has, until recently, taken place without disruption from losses due to insolvencies, other credit-related difficulties, or market manipulations.

The uncertainty created by Lombard-Wall and the other events described above casts a cloud over the future health of the repo market, and more important, creates a risk of market "grid-lock" should a repo participant become insolvent. This risk arises from the interconnected chain of transactions that typifies the use of repos. A single security may be transferred subject to a repo agreement and then may be transferred in another repo entered into by the transferee. This process may be repeated several times. Failure by any party in the chain to carry out its obligations thus can tie up the capital of numerous other parties and lead to serious disruption of the market.

Indeed this new uncertainty in the treatment of repos under the Bankruptcy Code had already led to contraction in certain sectors of the repo market. Moreover, recent regulatory events have created the prospect that significant additional contractions in the use of repos may occur in the new future unless the treatment of repos under the Bankruptcy Code is clarified. Let me give you just a few examples:

(a) In September, 1982, Standard & Poor's Corporation announced that, effective immediately, it will not rate "structured municipal issues" which permit investment of bond or note proceeds in repurchase agreements with government securities dealers whose securities are not rated by S&P. S&P noted that this new policy would remain in effect till clarification of the treatment of repos under the provisions of the Bankruptcy Code, particularly relating to the automatic stay. Financings that permit repos with banks and thrifts (whose liquidation is not covered by the automatic stay provisions of the Bankruptcy Code) will continue to be rated. It turns out as a practical matter, however, that very few, if any, nonbank government securities dealer in the United States issue securities that are rated by a securities rating agency such as S&P. Without a further clarification, this is a "catch-22" situation for both municipal investors and the government securities dealers.

(b) On October 25, 1982, the U.S. Department of Housing and Urban Development issued a memorandum precluding public housing authorities and FHA-Approved Mortgagees for Multifamily Projects from investing funds in repos. It noted that this order would remain in effect until the legal questions regarding the ownership of the securities used as collateral in repos was clarified.

(c) On November 4, 1982, the Securities Exchange Commission's Division of Investment Management, in a memorandum to Chairman Shad, indicated that in light of the new uncertainty under the Bankruptcy Code it would revise a previous "no action" position regarding investments by mutual funds in repos and require that investment company boards of directors, to the extent practicable, evaluate the creditworthiness of the brokers or dealers with which they propose to engage in repo transactions and that it would require that government securities money market funds which advertise that their portfolio securities are government guaranteed disclose substantial investments in repos. We agree that mutual fund management should always make broker dealer credit evaluations. But the present uncertainty of repos under the Bankruptcy Code places a serious new burden on investment company boards of directors in making that evaluation.

(d) On January 12, 1983, the New York State Senate Committee on Investigations and Taxation released a report reviewing the investment standards and accounting practices of 25 New York Agencies. In this connection New York State has been so concerned with the uncertainties prevailing in the repo market that it no longer participates directly in repos.

RESPONSES OF THE REPO MARKET

We may not know for some time the full dimension of the impact of Lombard-Wall and related events on the repo market. The current upswing in the government securities market probably has masked some of this impact. In addition, it appears that many participants are staying in the repo market on the assumption that corrective bankruptcy legislaton will be passed in the near future. Nonetheless, there are indications that sharp changes may be impending. Preliminary responses from a sample of PSA members tend to indicate that:

- Transactions by state and/or municipal governments and public authorities, as a percentage of total transactions, appear to be declining. The same appears to be true of transactions by pension funds and by commercial banks (acting on their own behalf as fiduciaries). In addition, the total volume of transactions by these customer categories appears to have declined.
- There appears to be decreasing participation by smaller government securities dealers in the repo market, with apparent contractions

during the period covering the collapse of Drysdale (5/12/82) and the reorganization of Lombard-Wall (8/7/82). In addition, there are indications that the smaller dealers have suffered a substantial decline in their customer base. Their customers appear to be transacting more repo business with the larger primary dealers.

- The proportion of repo transactions entered into with non-dealers (mutual funds, pension funds, state and municipal authorities, etc.) appears to have substantially decreased since May 1. This would mean that external sources of repo funds to finance the inventories of government securities are diminishing.
- As a corollary to the foregoing, the proportion of bank loans is increasing substantially as a factor in dealers' financing of inventories. The New York Fed's[1] figures show that the absolute level of dealer bank loans rose from approximatedy $2.1 billion on May 5, 1982, to $4.3 billion on November 17, 1982. During the same period bank loans as a percentage of total dealer positions in U.S. government and money market securities rose from 8.9% to 17.3%. This greater use of bank loans increases the dealer cost of financing because bank loans are a more expensive form of financing than repos.

These effects on the repo market to date, while highly significant, merely foreshadow the changes that appear imminent. For example, it is reported (although it is too early for available figures to demonstrate) that the related importance of repos in the portfolios of many mutual funds has sharply diminished and mutual fund executives are predicting even greater decreases in light of the SEC's proposed action.

Future Effects

If the indications discussed above reflect market trends and such trends continue, various adverse effects may be expected to occur. One effect would be an increase in the cost of financing the public debt. If dealers in government securities must find alternatives to repos to finance their inventories, these alternatives, such as bank loans, will almost certainly be more costly to the dealers and will ultimately increase the yield such dealers will have to seek in purchasing securities from the government.

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[1] Table I contains New York Fed figures as summarized by Merrill Lynch.

A fundamental alteration in the structure of the government securities market may also occur should this issue remain unresolved. For example, investors (such as money market mutual funds) may seek directly to purchase short-term Treasury obligations instead of taking short-term repo positions in long-term government securities. Such a phenomenon may create difficulty for the United States (and U.S. government agencies) in placing longer term obligations. In addition, this could promote increased volatility in the short-term market as institutions purchase and sell large quantities of short-term instruments.

Other adverse consequences could include concentration in the market for government securities and the gradual disappearance of smaller dealers from that market.

CONCLUSION

The repo market plays a critical role in our domestic capital market, both as a source of the funds and securities required for the efficient operation of the primary and secondary market in U.S. government securities and money market instruments, and as a money market investment vehicle in itself. Any constriction of the repo market resulting from uncertainty as to its legal status would increase costs for many groups of participants in capital markets, deprive many investors of a vehicle that is not only profitable but also uniquely capable of minimizing market risk, diminish the capacity of dealers and investors for absorbing the new debt issues required to meet public and private demand for credit, and damage the ability of market-makers to provide liquidity to the secondary market for government and other securities.

There are preliminary indications that such a constriction already has begun to occur and that it could become significantly more severe in the weeks and months to come. Early Congressional action could avert this danger. Therefore, PSA urges the Congress to promptly consider the Federal Reserve Board's proposal.

TABLE I

FINANCING BY U.S. GOVERNMENT SECURITIES DEALERS

(IN BILLIONS OF DOLLARS)

	TOTAL DEALER OUTSTANDINGS						
	ALL CUSTOMERS		EXCLUDING TRANS. * WITH OTHER DEALERS		DEALER BANK LOANS	BANK LOANS AS A % OF TOTAL DEALER POSTIONS IN U.S. GOV'T AND MONEY MARKET SECURITIES	
	Reverses	Repos	Reverses	Repos			
DEC. 30 81	80.098	101.347	33.109	45.323	1.971	9.5%	REFLECTS PRE-DRYSDALE
JAN. 6 82	74.016	93.299	30.202	44.591	1.604	6.8	
JAN. 13 82	71.440	89.049	29.501	40.982	1.904	10.3	
JAN. 20 82	73.778	88.051	30.078	39.386	1.553	10.6	
JAN. 27 82	71.319	84.052	28.986	36.408	1.486	10.1	
FEB. 3 82	72.872	86.532	28.210	35.585	1.578	11.4	
FEB. 10 82	67.796	80.293	26.901	34.116	1.083	7.7	
FEB. 17 82	68.526	83.120	26.901	37.346	0.872	7.6	
FEB. 24 82	68.500	78.305	26.822	35.045	1.712	10.2	
MAR. 3 82	64.177	78.341	23.879	33.415	1.721	8.6	
MAR. 10 82	69.589	85.846	24.556	36.390	1.440	5.8	
MAR. 17 82	69.094	91.696	30.925	46.501	1.463	6.7	
MAR. 24 82	67.256	89.437	27.844	46.141	1.702	6.8	
MAR. 31 82	66.649	89.537	26.745	46.720	2.018	8.0	
APR. 7 82	70.256	92.884	30.532	49.145	3.168	11.3	
APR. 14 82	69.536	91.708	30.052	49.395	1.718	6.4	
APR. 21 82	75.368	97.420	30.754	51.278	2.382	9.3	
APR. 28 82	81.906	103.532	35.619	53.060	1.443	6.1	
MAY 5 82	79.855	101.711	34.609	55.324	2.077	8.9	
MAY 12 82	78.340	103.008	34.072	54.382	2.426	8.8	
MAY 19 82	70.709	96.929	32.257	52.674	2.524	9.0	REFLECTS DRYSDALE
MAY 26 82	67.311	92.578	27.518	48.465	2.652	8.4	
JUN 2 82	65.012	91.604	27.785	46.899	2.991	10.0	
JUN 9 82	63.873	[illegible]	27.504	47.558	2.318	8.1	
JUN 16 82	61.372	[illegible]	27.083	45.760	2.478	8.9	
JUN 23 82	66.055	87.373	27.919	46.428	2.102	9.2	
JUN 30 82	70.937	90.015	31.285	47.671	2.422	11.0	
JUL 7 82	69.771	90.102	32.228	49.388	1.919	8.5	
JUL 14 82	68.078	88.911	28.656	46.347	2.133	7.6	
JUL 21 82	71.610	91.582	28.336	47.093	3.011	11.2	
JUL 28 82	76.650	99.330	28.457	50.515	3.294	11.6	
UG 4 82	90.395	100.018	27.955	47.826	4.093	15.2	
UG 11 82	77.435	99.135	26.872	46.611	2.037	7.5	
UG 18 82	79.846	97.948	27.491	45.998	3.680	14.4	REFLECTS LOMBARD-WALL
DG 25 82	81.809	98.937	26.729	44.726	2.698	13.7	
EP 1 82	81.457	97.516	25.473	42.970	3.435	19.5	
EP 8 82	77.182	92.519	24.999	42.264	3.387	16.4	
EP 15 82	79.855	96.468	25.165	43.619	3.470	17.2	
EP 22 82	82.521	96.548	26.727	44.821	3.563	19.5	REFLECTS LOMBARD-WALL DECISION
EP 29 82	80.721	96.745	25.568	44.487	4.343	23.4	
OCT 6 82	78.218	91.530	23.940	40.578	4.151	20.8	
OCT 13 82	78.666	95.735	25.648	43.918	4.144	18.3	
OCT 20 82	82.132	97.155	26.760	41.973	4.704	21.2	
OCT 27 82	81.236	96.431	25.823	42.838	3.978	17.5	
NOV 3 82	83.645	95.802	27.904	43.864	5.277	23.5	
NOV 10 82	82.241	97.568	28.026	43.999	3.421	14.2	
NOV 17 82	84.128	98.305	29.360	45.226	4.258	17.3	

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

December 13, 1982

The Honorable Robert J. Dole
Chairman
Subcommittee on Courts
Committee on the Judiciary
United States Senate
Washington, D.C. 20510

Dear Chairman Dole:

On September 29, 1982 I wrote to you recommending a change in the Bankruptcy Reform Act of 1978 ("Code") to remove a possible technical impediment to the effective functioning of the market for repurchase transactions ("repos"). On behalf of the Board of Governors I would like to restate that support and to request legislative action at the present Special Session of Congress. The Board believes that this action would restore repos to the status participating parties anticipated they would possess.

As I noted in my September letter, a recent development in the repo market--specifically the bankruptcy of an active dealer in that market--has raised the possibility that in the future the financial problems of a particular institution could unnecessarily impair the liquidity of a wide range of other firms. Because of the magnitude of the market--over $100 billion outstanding every day--and the importance of repos to the Federal Reserve as an instrument for the conduct of monetary policy, it is desirable to establish an environment that will assure smooth functioning of this financial market and avoid any potential for a serious ripple effect on financial markets generally.

A repurchase transaction represents a transfer of a financial instrument of some kind--often a government security--and a simultaneous agreement requiring a return of the security at a fixed date and at a price which reflects a rate of interest to be paid by the transferee. The term of repos usually ranges from one day to one week, although they sometimes extend for longer periods. Repo transactions are especially attractive to market participants, providing a high degree of flexibility as to term and amount to be invested, and are used by a wide range of entities to earn interest on temporarily idle funds. Market participants include government securities dealers, states, municipalities and other public bodies, financial institutions, pension funds, and money market mutual funds.

It had been thought by the market that these transactions were both highly liquid and secure beyond question. However, the bench opinion of the United States Bankruptcy Court for the Southern District of New York in September, 1982, in the bankruptcy case of Lombard-Wall, Inc., held that the automatic stay against creditor action prevents the holder of securities acquired under a repurchase agreement from liquidating those securities and closing out its transaction with the debtor. The decision casts doubt on the safety and liquidity of repo transactions because it subjects the holder both to unexpected inability to liquidate securities it holds and to the risk of capital loss should unfavorable interest rate changes occur; these risks impair the qualities that are the essence of the appeal of repo agreements. Because the securities cannot be liquidated without permission of the court, the investor bears the risk of changes in interest rates that may decrease the value of the underlying securities, with a final determination as to the distribution of the securities often delayed for at least two months and possibly years. In a market in which prices may fluctuate widely, such a delay could result in substantial losses to investors.

If this decision becomes the law governing these transactions, the failure of one market participant and the inability of other parties promptly to liquidate their investments to obtain cash to meet obligations could have a ripple effect throughout the securities market, causing an otherwise isolated financial problem to spread to many other entities. Participants would not receive their funds as expected and would either have to default on their commitments to third parties or borrow funds, if they could, to fulfill these commitments, thus incurring additional expenses. For example, a money market mutual fund that had put out funds in a repo transaction may experience increased redemption demands once shareholders became aware of the fund's liquidity problem. Even if the fund were able to meet ordinary demands, it might not be able to meet the unusually high demand for redemption of shares produced by public perception of a problem.

The proposed amendments would resolve the potential structural problem by exempting certain repos from the automatic stay in bankruptcy. In my September letter I stressed the desirability of drawing the legislation in a narrow manner to avoid major exceptions to existing bankruptcy law. Thus the Board continues to believe that the protection provided by the proposed legislation should be limited to those markets which are so large as to raise potential systemic problems in situations in which a bankruptcy could affect the liquidity and solvency of a large number of other entities, particularly fiduciary entities. Accordingly, the Board supports limiting the scope of the legislation to the repo markets in U.S. government and agency securities, bankers' acceptances, and certificates of deposit and to repo transactions of $1 million or more. The legislation, however, should not be regarded as affecting the legal status of repos on other types of assets, such as commercial paper.

Investors who deal in repos are seeking a safe investment that protects liquidity. To subject these investors to the risks that could arise in the event of bankruptcy of a repo dealer could affect the willingness of investors to participate in this market. Because of the important role repo transactions serve, particularly for the implementation of monetary policy, it is desirable that the market be protected from unnecessary disruption.

The Federal Reserve uses the repo market to affect the supply of reserves. For example, in 1981, the System entered into over $110 billion of repo transactions for monetary policy purposes. Such transactions are useful in helping to smooth out short-term swings in bank reserves that would otherwise increase the volatility of interest rates. A repo market that has been narrowed by the withdrawal of participants that are unprepared to accept the risks inherent in the Lombard-Wall decision, could limit the ability of the Federal Reserve to act promptly and in the large volumes necessary to achieve its monetary policy objectives.

It would be desirable if market mechanisms could be used to avoid the risks inherent in the court's construction of the Bankruptcy

Code. However, a detailed examination of this problem indicates that there are no really effective methods for hedging against these risks, leaving legislative action as the best method of clarifying the law and avoiding a structural problem for the financial markets.

The proposed Code amendments are designed to protect the repo market, rather than any particular group or class of market participants. In this way, they are parallel to a similar action by Congress last July that exempted securities and commodities dealers from the automatic stay in order to minimize the "ripple effect" that would take place in the commodities or securities market should a large securities or commodities firm file a case under the Code.

The Board requests that the amendments proposed be enacted promptly in order to return repurchase agreements to the status they held before the Lombard-Wall decision, thereby preserving the repurchase agreement as an important tool of monetary policy and assuring the stability of the nation's financial markets.

Sincerely,

Paul A Volcker

SHOPPING CENTER TENANCY AMENDMENTS

Senator DOLE. We have another matter here that is noncontroversial, that is the shopping center amendment bill. Gentleman, maybe you can speed this up.

STATEMENTS OF IRVIN B. MAIZLISH, PRESIDENT, LEO EISENBERG & CO.; NATHAN FEINSTEIN, COHEN, SHAPIRO & POLISHER; AND JOHN S. HOLMES, SR., PRESIDENT, FREDERICK, MD., SHOPPING CENTER MERCHANTS ASSOCIATION

Mr. MAIZLISH. My name is Irvin B. Maizlish. I am the president of Leo Eisenberg & Co. of Kansas City, Mo. Our company is the largest developer of unenclosed commerical shopping centers, commonly called neighborhood or stoop centers, in the United States, which operates over 120 centers in several States, including Arizona, North and South Carolina, Colorado, Illinois, Arkansas, Iowa, Kansas, Missouri, Nebraska, New Mexico, Texas, and Wyoming.

I am also chairman of the Small Center Developers Committee and a member of the board of trustees of the International Council of Shopping Centers [ICSC]. The ICSC is an association of approximately 10,000 developers, owners, retailers, and financiers of shopping centers and retail companies operating stores in shopping centers, who collectively represent a major share of the estimated 22,700 shopping centers in the United States.

I am testifying today on behalf of my firm, as well as ICSC, in support of legislation which passed the Senate last year as the Shopping Center Protections Improvements Act of 1982, S. 2297. The purpose of this legislation is to remedy very serious problems affecting shopping centers and their solvent tenants because of the administration of bankrupt tenants' leases.

A shopping center is a legally and economically interdependent combination of retailers, almost like a city. Its commercial success depends on the full-time operation of stores which engage in carefully selected and often precisely specified business activities, which advertise in ways that draw customers to the shopping center, and which maintain certain standards of appearance and operation.

This joint effort is cemented by a series of long-term agreements entered into by all of the parties involved in a shopping center. Unlike a merchandise creditor or a financial institutional lender, shopping center tenants and landlords are unable to terminate their relationship with a business when they feel that the business' capacity to perform its obligations is impaired because of these long-term agreements.

Because of the unique interdependence of a shopping center and its tenants, shopping centers require special consideration when contractual obligations are altered under the bankruptcy law. Congress recognized this fact when it enacted the Bankruptcy Reform Act of 1978, and provided specific protections for shopping centers and their tenants in section 365 of the Bankruptcy Code. Unfortunately, these protections have not worked as intended.

Shopping center leases administered under the Bankruptcy Code have been partially operated or abandoned, the space has been used for purposes other than those permitted under the lease and contributing to the business of the other tenants, and debtors have failed to pay their rent and their share of the common area costs. These actions have seriously disrupted the business of the entire shopping center.

When tenant space is not operated fully, especially the space of a major tenant, customer traffic in the shopping center is reduced by the decreased supply of products or services and because of the less pleasant atmosphere resulting from the boarding up of a portion of the shopping center. The operation of businesses not permitted by the use clause of the lease and which detract from the image of the center also reduces the sales of the other tenants. Where the vacant or improperly used space is that of an anchor store, the effect on a shopping center and its other tenants can be devastating.

For example, our firm is presently involved in a bankruptcy proceeding involving the anchor tenant of an Omaha, Nebr., shopping center over 18 months ago. This tenant filed for bankruptcy under chapter 11 over 18 months ago, in July 1981. From that time until the space finally was completely abandoned last month, the tenant abandoned half of its space, operated the store at irregular hours, frequently did not open on weekends, and failed to properly stock its merchandise. In addition, the tenant failed to make payments for rent, taxes, insurance, and common area charges in the amount of $88,000. Despite its failure to honor its obligations under the lease, and despite the fact that we had a number of suitable replacement tenants willing to take over the space, the bankruptcy court refused to allow us to regain control of the lease, in the hopes that the bankrupt could solve his problems.

Because the bankrupt store was the major tenant of the shopping center, with over 80 percent of the shoppers of the center doing business there, its inadequate operation for 1½ years severely reduced the sales of the other tenants. During this time, the business of the other tenants in the shopping center declined by as much as 40 percent. The sales of other Omaha retailers were flat over this period. We believe that the entire decrease was due to the bankruptcy problem. In addition, the bankrupt's failure to pay common area charges increased the other tenants' costs of maintaining the common area of the shopping center by 60 percent. As a result of this double-barreled effect on my other tenants, several are in grave financial difficulty today.

Moreover, the store next to the bankrupt, which formerly had been a healthy business, was itself driven into bankruptcy because its loss of business, the sale of stereo equipment, which was heavily dependent for customer traffic on the business of the bankrupt anchor tenant, a huge operational discount record chain.

As the members of the subcommittee are well aware, the number of business bankruptcies has been increasing substantially. The problems caused by the present administration of the Bankruptcy Code are serious and widespread, affecting an estimated two-thirds of all shopping centers.

I urge Congress to act on the shopping center bankruptcy amendments as soon as possible to avoid further unnecessary harm to shopping centers and their tenants.

I thank the subcommittee for its consideration of my views. I will be happy to answer any questions.

Senator **Heflin**. As I remember, there were three points brought up in previous hearings. One, bankruptcy officials say, "Do not delay, do not disturb our mix, and do not disturb the lease."

Is there anything else that we need to be informed of other than what is in your written statement?

Mr. **Maizlish**. Nothing else. If the bankruptcy court cannot decide within 60 days, we can bring another tenant in and get the show on the road.

The problem that so many people do not realize is that in these centers, they live off the major tenants, and we have mom and pop stores go under because the major tenant is gone.

Take the Woolco situation. Woolco is closing the stores, and every landlord has the opportunity to work with them and we are getting tenants.

Grant went bankrupt years ago, and it worked out under the old bankruptcy law.

Senator **Dole**. I know you raised this last year, and we had hearings.

If we can conclude this hearing in 5 minutes, we will do so, or come back at 2 o'clock.

Mr. Feinstein, please proceed.

Mr. **Feinstein**. My name is Nathan Feinstein. I am a Philadelphia lawyer. I hope to give the lie to the idea that Philadelphia lawyers always end up with convoluted statements, and we also know when to shut up.

The shopping center bill, S. 2297, you had extensive hearings on that last year. Senator Heflin's characterization is correct. The provisions have not changed materially. They would require assumption cr rejection of a lease unless one seeks court approval for an extension of time. That would parallel chapter 11 with chapter 7 as it is today.

It would require performance of the lease or other executory contract pending the determination to resume or reject, and would require assignments to be bound with the same sorts of terms that the current lease implements.

The only comment I would make in addition to that is that, if anything, the need for provisions of this sort, which operate more automatically than current provisions operate, is greater today. That is true in part because of the chaos caused by the administrative rule as it is currently functioning in the courts. There are greater delays. It is not functioning well.

Second, the several proposals described today for dealing with the article III problem all seem to contemplate a reduction in the number of judges and effective judicial personnel. That will make the need for relatively self-operating provisions in the code, I think, greater rather than lesser.

Senator DOLE. Mr. Holmes?

Mr. HOLMES. I am John Holmes, from Frederick. I am president of the Merchants Association in Frederick and I do concur totally—I have been president for 12 years now—and I do concur with Leo on his problems as a shopping center owner.

When two stores went into bankruptcy last year, we had our troubles in our center, and this is with customers accounts dropping considerably, as low as 28 percent in our center.

We had this year a transition with Woolco, which went out 2 weeks ago and we are finding at least a 10-percent drop in our customer accounts already in 2 weeks, and we understand that in another 2 weeks we will have the store coming in, probably a month in getting it back into shape, ready for operation, and this makes a smooth transition, makes all the merchants a lot more comfortable, and keeping their personnel on board.

A few years ago when we had our problem, a lot of people were getting ready to be let go because of our problem.

Thank you.

Senator DOLE. Your statements have been made part of the record. I have no questions, but if there should be something in addition that would arise, we would try to work it out on a staff level without additional hearings.

Thank you very much.

[Submissions of Messrs. Maizlish, Feinstein, and Holmes follow:]

STATEMENT OF
THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS
PRESENTED BY
IRVIN B. MAIZLISH

SUMMARY OF STATEMENT

As Congress recognized in enacting the Bankruptcy Reform Act of 1978 (the Bankruptcy Code or the Code), shopping center leases are unique among all leases of real property in that each lease arrangement involves not only the interests of that tenant and the landlord, but the interests of every other tenant of the shopping center. A shopping center is a combination of retailers each dependent on the others to attract shoppers to a specially designed structure intended to facilitate and encourage shopping. Thus, there is an interrelationship among the tenants of a shopping center such that the bankruptcy of one tenant has a serious impact on the other tenants.

Prior to the enactment of the Code, in the case of the bankruptcy of a tenant, the interests of the shopping center and its other tenants were protected by the contractual power of the lessor to control the disposition of the lease. Under the Code, clauses permitting the lessor to terminate the lease are unenforceable. However, because Congress recognized the special problems of shopping centers, special provisions regarding unexpired shopping center leases were included in the Code. These provisions, sections 365(b)(1)(C) and (b)(3), specify various assurances which the trustee is required to make in order to assume or assign an unexpired lease of the debtor.

Experience with these provisions indicates that they have not been functioning as originally intended by Congress. Several substantive and technical problems have arisen as follows:

A. Substantive Problems

1. The Code gives the trustee an option to assume or reject an unexpired lease. No time limit is established in the Code (except for liquidation cases), and an extended period of time can pass with the shopping center owner not knowing the disposition of the lease. if the space is not used as a retail store, the entire center can suffer irreparable injury because of decreased traffic, especially in the case of a major (anchor) tenant.

To remedy the problem, a 60-day time limit should be placed on the trustee's decision to assume or reject a lease; the court could allow additional time for cause.

2. During the time the trustee is deciding whether to assume or reject a lease, the landlord frequently does not receive rent and other payments required under the lease. Because common area charges are often paid by the tenants in proportion to the leased area, the failure of one tenant to make such payments increases the amounts which must be paid by the other tenants. Since the landlord has been deprived of his contractual right to terminate the lease upon bankruptcy, it would seem fair to require the trustee to perform all the obligations under the lease, including the payment of rent and other charges specified in the lease until the lease is assumed or rejected.

This change would alter current law which permits a trustee to pay a warehouse value for space no longer being used for retail sales. These kinds of reduced payments are particularly onerous to a shopping center landlord who has usually obtained financing based on receiving rent from retail use.

3. The Code requires "substantial" compliance with the lease provisions of critical importance to shopping centers. This word introduces an ambiguity into the law as to how great a deviation from the lease provision should be allowed and its inclusion in the Code has been the basis for the Bankruptcy Courts' allowing lease assignments to be made to businesses in violation of the use clause with the resultant disruption of the tenant mix in the shopping center. This ambiguity should be removed and full compliance with these clauses should be required.

4. If the trustee assigns the lease to a new tenant, the landlord is placed in the highly unusual position of being forced into a business relationship similar to a joint venture with a person he has not selected. The law should at least assure that the new tenant meets the landlord's general financial requirements and require that the new tenant have a financial and operating performance similar to that of the original debtor-tenant when the lease was first executed.

5. If the trustee assigns the lease to a new tenant, the law should specify that the landlord is entitled to his customary security deposit from the new tenant.

B. Technical Amendments

1. A problem has arisen because some trustees do not believe that the Code requires an assignee of a shopping center lease to comply with the use and other clauses contained in the lease being assumed, but only with the provisions of other leases or agreements involving the shopping center. The Code should be clarified to provide that the new tenant must comply with all the provisions of the lease being assumed as well as assuring that there is no breach in other documents relating to the shopping center.

2. The critical provisions of the Code applicable to shopping centers only apply if there has been a default in the lease. These provisions should apply to any assignment of the lease whether or not there has been a default.

3. If a lease has terminated under state law prior to bankruptcy by reason of its own terms or a judicial order, that lease is no longer property of the debtor and it should not be subject to the bankruptcy proceedings. We believe the law should clearly so provide.

4. It is possible that a lease may terminate by its own terms while the bankruptcy proceedings are still pending, e.g., the term of the lease comes to an end. The Code should make it clear that the landlord can recover possession of the premises in such a situation.

I. Introduction

My name is Irvin B. Maizlish. I am the President of Leo Eisenberg & Co., Inc. of Kansas City, Missouri. Our company was founded in 1938 and is the largest developer of unenclosed shopping centers in the United States. Leo Eisenberg & Co., Inc. owns over 120 shopping centers in several states, including

Arizona, North and South Carolina, Colorado, Illinois, Iowa, Kansas, Missouri, Nebraska, New Mexico, Texas and Wyoming. I am also the Chairman of the Small Center Developers Committee and a member of the Board of Trustees of the International Council of Shopping Centers (ICSC). Today I am testifying on behalf of my firm and the ICSC.

The International Council of Shopping Centers (ICSC) is a business association of more than 10,000 members. About 63% of our members develop and/or own shopping centers. About 15% are retail companies, the major share of whose stores are operated in shopping centers. Most of our developer-owner members own from two to four shopping centers each, and collectively represent a major share of the estimated 22,700 shopping centers in the United States in 1982.

Contrary to the obvious Congressional intent, the 1978 Bankruptcy Reform Act unnecessarily and unreasonably impairs the right of a landlord to adequate remedies in the event of a tenant bankruptcy. As a result, the non-bankrupt tenants and the shopping center are often damaged by the arbitrary and capricious administration of the bankrupt estate by the bankruptcy trustee or court.

I am testifying in support of legislation which passed the Senate last year as The Shopping Center Protections Improvements Act of 1982, S. 2297, and which was included in the omnibus bankruptcy package developed by the Committee last year as the Leasehold Management Amendments. I will refer to the provisions of this legislation as the shopping center bankruptcy amendments. These amendments would eliminate certain inequities in the current Bankruptcy Code and would provide more predictable administrative remedies.

A shopping center is a combination of retailers each dependent upon the others to attract shoppers to an especially designed structure intended to facilitate and encourage shopping. As a result of such a relationship, the bankruptcy of one tenant often has a serious impact on the other tenants. A successful shopping center is typically the result of sophisticated planning and a delicate balance of merchants. Tenants are chosen on the basis of their business image and use, an analysis and evaluation of the market demands of the area and an examination of the financial capacity and business experience of the tenants in relation to the potential customers to be served. A well-planned project with a balanced mix of stores maximizes the potential benefits to the landlord, the tenants, and the community served.

Shopping center leases are necessarily made on a long-term basis considering the large investment usually made by tenants in preparing their establishments for the contemplated business. These long-term lease arrangements, which are granted to tenants for specific and limited uses of the landlord's property for long periods of time, put the landlord into a position unlike that of a merchandise creditor or financial institutional lender. Such suppliers or lenders can make periodic short-term reviews of the financial condition of their customers and can freely terminate credit when they feel the customers capacity to pay is impaired. A landlord under a long-term agreement cannot do so.

Shopping center leases usually contain strict limitations on use, affirmative covenants relating to radius clauses (forbiding the dilution of tenants market potential), prohibitions on assignments unless the landlord is satisfied with the financial stability, credit, public image, and intended use of the potential assignee, and specific requirements for cooperative advertising, promotion, common area use and maintenance, sign control, and uniform hours of operation.

The vacancy of any tenant space for an extended period of time can seriously disrupt the businesses not only of the neighboring tenants but of an entire shopping center. Customer traffic is reduced not only by the decreased supply of products or services, but also by the less pleasant atmosphere resulting from the "boarding up" of a portion of the shopping center. Where the vacant space is that of an anchor store, the effect on the shopping center and its other tenants can be devastating.

The assignment of a lease to a tenant in the same business as other existing tenants might substantially reduce the revenues of these tenants, thereby jeopardizing their solvency and affecting their ability to pay their rent. In addition, the amount of the guaranteed minimum rent and the percentage rental rates paid by shopping center tenants in most instances is dependent upon the type of business of that particular tenant. Some businesses traditionally pay higher square foot rentals and have higher percentage rentals than tenants operating other businesses. The assignment of a lease to a tenant in a business other than that of the assignor could give the assignee an unfiar advantage over existing tenants in the same business who are paying the higher rental rates consistent with the nature of their business.

Prior to the enactment of the Bankruptcy Reform Act of 1978 (the Code), the shopping center owner could protect the rights and interests of the other tenants in the shopping center by enforcing contractual lease provisions permitting the termination or restricting the assignment or other disposition of the lease in the case of a bankruptcy. Under the Code such provisions became unenforceable, and the fate of the lease came under the control of the trustee of a bankrupt tenant.

Such trustees are granted considerable discretion under the Code, particularly in Chapter XI proceedings. However, Congress recognized the special problems of shopping centers by enacting special provisions applying to shopping centers in Sections 365(b)(1)(C) and (b)(3), specifying the criteria which the trustee is required to meet in order to affirm or assign an unexpired lease of the debtor.

Unfortunately, in actual practice the specification of such criteria has not proved adequate to provide the kind of protection which Congress intended. For instance, one of the most oppressive problems faced by shopping centers results from the failure of the Code to require the trustee to accept or reject the unexpired lease within a specified time limit in a nonliquidation bankruptcy proceeding.

Also, there is no time limit specified requiring the trustee to release jurisdiction over an unwanted leasehold or even an expired lease in order to allow the landlord to institute proceedings to recover possession. This is so even though the former tenant has filed to vacate the premises, or the lease has expired and the tenant is holding possession by sufferance only.

Some trustees refuse to recommend release of the premises even where they know full well that there is no interest of the tenant to be preserved for the bankruptcy estate. In the meantime, the landlord may not re-rent the premises or prosecute any action to recover possession because all state court proceedings are "stayed." Other non-bankrupt tenants are usually damaged by the vacancy. On some occasions, even where the trustee has recommended that the property be released to the landlord because there is no value to be preserved for the bankruptcy estate, the court rejects the recommendation or merely avoids making any decision.

For example, in July 1981, Nehi Distributors and its subsidiary Peaches Records filed for bankruptcy under Chapter 11. Over the next several months, Peaches sold the leases for 33 of its 34 United States' stores. The lease that it did not sell was for space located in a Leo Eisenberg & Co. shopping center in Omaha, Nebraska. Peaches Records was the anchor tenant in the shopping center, provided the major customer attraction power for the shopping center, and leased 38,000 square feet of space there.

From July 1981 until December 1982, when it abandoned the premises, Peaches Records operated the space only on a sporadic basis. Its hours of operation varied and it was frequently not open on weekends. It also frequently failed to properly stock its store. In addition, during this time Peaches Records constricted its operations within its leased space, leaving one-half of the space vacant.

From July 1981 to October 1982, Peaches Records occasionally paid the rent for its space in the Omaha Shopping Center, but made no payments for taxes, insurance and other charges called for in the lease.

Because of Peaches failure to adequately operate its space and its failure to pay substantial amounts of rent and other charges, we sought to regain control of the lease. Despite the fact that we have over 20 appropriate, viable businesses willing to lease this space, the Bankruptcy Court has denied our repeated requests that the lease be rejected and that the debtor-in-possession be required to pay its rent, taxes, insurance and other charges.

In July of 1982, after again refusing our request to reject the lease, the judge directed us to come to some accommodation with the tenant under which half the leased space would be deemed rejected, and the other half would continue to be leased. Throughout this process, the trustee assured us that once this issue was settled Peaches would pay its back rent, taxes and other charges.

Although such an agreement was reached, on the day before the date set for a hearing to finally settle this matter, Peaches informed us that it would only be able to pay one-half of the amount of back rent, taxes and other charges due. The bankruptcy judge ruled that Peaches could retain one-half of the leased space and reject the other half upon payment of one-half the amount of the back rent, taxes, and other charges due, and upon delivery to us of a personal note of the President of Peaches. The court permitted this settlement to be imposed on the shopping center despite the facts that the President of Peaches had previously filed for personal bankruptcy, and that Peaches' business showed no signs of being viable.

On September 1, 1982, the President of Peaches began to operate the business in the reduced space in the shopping center. The business continued to fail and it was finally abandoned and the premises vacated on December 26, 1982. It is still vacant. We do not yet have control over the space and do not know when we will be able to re-lease the space. The next hearing is set for February 23 and that will be the earliest time we can finally settle this matter. No payments for rent or other charges were made during the time Peaches' President was operating the store.

From July 1981 until December 1982, the anchor tenant in the Omaha shopping center was operating in a reduced, sporadic and inadequate manner, much of the time with half of its space abandoned. Since July 1981, I have been unable to regain control of the lease and re-lease the space to a suitable operating tenant. This situation had a detrimental impact on all the other tenants of the shopping center, and especially on the tenant adjacent to Peaches.

The sales of the other tenants in the shopping center have declined 40 percent since the Peaches bankruptcy. Inasmuch as the sales of retailers generally in the Omaha area have been flat over this period, we believe that the entire 40 percent reduction is due to the Peaches bankruptcy. Many of the other tenants have had problems maintaining their solvency during this period, and they tell me that their problems are the result of the inadequate operation of the Peaches store.

The most serious impact of the operation of the Peaches store under the Bankruptcy Code, however, has been on the store adjacent to Peaches. This tenant was a stereo store which depended heavily for its customers on the customer traffic generated by Peaches Records. Before the Peaches bankruptcy, this was a sound, healthy business. The placement of Peaches Records next to the stereo store is an example of the synergistic effect of a carefully developed shopping center tenant mix. The fortunes of the stereo store were closely tied to those of the record store. As a result of the operation of Peaches Records as a debtor-in-possession, the stereo store has recently gone into bankruptcy itself.

Since July 1981, Peaches has failed to pay $88,000 in rent and in other charges. This has caused the expenses of the other tenants to increase by approximately 60 percent because of Peaches' unpaid share of the costs of operating the common areas of the shopping center. Thus, the other tenants have been injured not only by the reduction of their sales revenues due to the reduced customer traffic in the shopping center, but also by the increased common area cost payments necessitated by Peaches' failure to pay its share of those costs.

Last year, Mr. Wallace R. Woodbury, Chairman of the Board of the Woodbury Corporation, testified about similar situations occurring in his shopping centers. The detrimental effects of a bankrupt tenant's ability to retain control over shopping center space while only partially operating it, or even abandoning it, and without paying the rent, taxes, insurance and other charges when due are believed to be widespread throughout the shopping center industry.

These are examples of the types of situations that would be cured by the language of the shopping center bankruptcy amendments. These provisions would provide reasonable protection to the landlord and the non-bankrupt tenants of a shopping center from the extended delays and losses resulting from the bankruptcies of other tenants in the shopping center.

II. The Unique Nature of Shopping Center Leases

After World War II, the changes in the patterns of American life produced by the advent of the automobile were accelerated, and nowhere were these changes more evident than in the retail industry. Previously, retail trade was concentrated in individual stores in central business districts, but by 1981, 42.0% of all U.S. retail trade amounting to $438.8 billion was conducted in shopping centers. It is estimated that in the 1982-83 period 60% of total new retail square footage constructed will be in shopping centers. In the same period about 88% of new department store square footage will be constructed in shopping centers.

What makes this type of operation possible is the understanding by all concerned that the commercial success of the enterprise depends on the finished product functioning as a unit, presenting to the public a single face.

What makes this type of operation desirable is the fact that experience has shown that a combination of tenants ("tenant mix") that is well designed to serve the "trade area" of a shopping center will have a symbiotic effect on business in the center that will benefit all of the tenants. It is for this reason that businesses are willing to pay a premium to directly compete with each other in close proximity in a shopping center.

The joint effort of a shopping center is cemented by a series of master agreements, entered into by all the parties involved in a shopping center, that set forth in precise terms the rights and obligations of each party.

When a center includes major department stores, it is common (but not universal) practice for the department stores to own their own buildings and, also, usually (but again, not always) some part of the land within the center's perimeter.

With the department stores each owning a share of the site and the developer owning the portion occupied by the satellite stores, and with the structures all physically tied together, a shopping center can become a complicated endeavor. To further complicate matters, each party finances its investment with a separate mortgage. The result is a real estate development in which numerous entities hold long-term, effectively inseparable interests.

The standard pattern always has been for the tenants to pay rent on the basis of a percentage of their sales volume or a guaranteed minimum amount, whichever is greater. Exceptions to the pattern have become progressively fewer; today they are rare and are confined to special situations.

As shopping centers have developed, they have become larger and more sophisticated in design, construction and concept, and they involve tens of millions of dollars of investments by the developer, the tenants, and financial institutions.

In addition, because of their size and impact on development patterns, the construction of a shopping center often involves the expenditure of millions of dollars of public money on infra-structure such as roads, traffic control, and water and sewage facilities. Of course, these expenditures are returned to the governments involved through taxes on the business activity generated by the shopping center.

Thus, a shopping center, if successful, is the product of considerable sophisticated planning and consists of a delicate balance of merchants. Tenants are chosen on the basis of their business use, their type of operation, the market they will cater to (age grouping, financial status, etc.), financial viability, and business experience. The choosing of types of tenants takes into consideration the needs of the surrounding community and the appeal of the stores, as a whole, to a broad segment of the population. A well planned project will have a percentage of ready-to-wear merchants, shoe stores, food establishments, gift shops, book stores, service establishments, etc. A center so planned is protective of the tenants, and the landlord, and satisfies as well the needs of the community to which it usually contributes considerable tax dollars.

This is true not only for large shopping centers, but also for small centers where independent merchants depend upon one another to attract customers from whom they mutually benefit.

Shopping center leases are necessarily made on a long-term basis considering the large investment usually made by tenants in preparing their establishments for the contemplated business. These long-term lease agreements granting to tenants the use of the landlord's property for such long periods of time puts the landlord into a position unlike a merchandise creditor or a financial institutional lender. Such suppliers or lenders can make periodic reviews of the financial condition of their customer and can, freely, stop credit or loans at such time as they, in their discretion, feel that the credit of their customer is impaired. A landlord, under a long-term agreement, cannot do so.

Moreover, shopping center leases frequently contain "anchor" clauses which commit a given tenant to a lease term only so long as another designated tenant remains a tenant in the shopping center. These provisions further manifest the symbiotic, interdependent nature of a shopping center.

III. The Consequences to Shopping Centers and Their Tenants of Vacant or Partially Operated Space or Space Used for Purposes Other Than Specified in Lease Agreements

As discussed above, the success of a shopping center, and thus of all of its tenants, is based in large part on its "tenant mix." To operate properly, the tenant space in the shopping center must be fully occupied by establishments operating at full capacity and offering products or services which, in conjunction with those offered by other tenants, are designed to maximize the attraction of customers to the shopping center.

The vacancy of any tenant space for an extended period of time can seriously disrupt an entire shopping center. Customer traffic is reduced not only by the decreased supply of products or services, but also by the less pleasant atmosphere caused by boarding up a portion of the shopping center. Where the vacant space is that of an anchor store, the effect on the shopping center and its other tenants can be devastating. Indeed, even a curtailment of the operation of an anchor tenant can substantially reduce the traffic of an entire shopping center.

Another consequence of the curtailment of operation of any tenant is a reduction of rental revenues to the shopping center. This occurs because almost all shopping center tenants pay rent which is, at least in part, based on a percentage of their sales volume. Typically, this percentage rental is at least as important to the shopping center as is the minimum base rental.

The operation of a shopping center can also be seriously impaired by the use of any tenant space for purposes other than those contemplated by the shopping center and its other tenants and provided for in a master lease or other agreement. For example, the assignment of a lease to a tenant in the same business as other existing tenants could substantially reduce their revenues, thus affecting their ability to pay their rent and jeopardizing their solvency. Moreover, interim or long-term loan agreements sometimes contain covenants restricting the type or quality of tenant which would be accepted in the shopping center. If the use provisions of a lease agreement are not complied with, the lessor could be in violation of such loan covenants, thereby causing acceleration of the indebtedness to the lessor's lender.

In addition, the amount of rent paid by shopping center tenants is in most instances based upon the business of that tenant's space. Tenants operating certain businesses pay a much higher square foot rental than tenants operating other businesses. The assignment of a lease to a tenant in a business other than that of the assignor could give the assignee an unfair advantage over existing tenants who are paying a higher square footage rent based upon the nature of their business.

IV. The Law Regarding Unexpired Shopping Center Leases Held by Bankrupt Tenants

A. The Law Prior to the Bankruptcy Reform Act of 1978

Prior to the enactment of the Code, in the case of the bankruptcy of a tenant, a shopping center was able to protect its interest and the interests of its other tenants by enforcing lease clauses permitting the lessor to control the lease. Shopping center leases thus generally provided that if insolvency proceedings were filed, the lessor could: 1) terminate the lease; 2) change the lease to a month-to-month tenancy; 3) waive or terminate an option to renew the lease; or 4) terminate the lease if the debtor was unable to maintain a certain sales volume or net worth.

Such provisions enabled the shopping center to avoid the adverse consequences of vacancies, curtailed operations or inappropriate uses described above in the event that any tenant became insolvent.

B. Section 365 of the Bankruptcy Code: Language, Structure and Legislative History

Section 365 of the Bankruptcy Code relates to executory contracts and unexpired leases. Subsections (a), (b)(1), (b)(3), (d)(1), (d)(2), (e)(1), (f)(1) and (f)(2) are of primary importance regarding unexpired shopping center leases. These sections provide as follows:

> (a) Except as provided in sections 765 and 766 of this title and in subsections (b), (c), and (d) of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor.
>
> (b)(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee--
>
> (A) cures, or provides adequate assurance that the trustee will promptly cure, such default;
>
> (B) compensates, or provides adequate

assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and

(C) provides adequate assurance of future performance under such contract or lease.

* * *

(b)(3) For the purposes of paragraph (1) of this section, adequate assurance of future performance of a lease of real property in a shopping center includes adequate assurance--

(A) of the source of rent and other consideration due under such lease;

(B) that any percentage rent due under such lease will not decline substantially;

(C) that assumption or assignment of such lease will not breach substantially any provision, such as a radius, location, use, or exclusivity provision, in any other lease, financing agreement, or master agreement relating to such shopping center; and

(D) that assumption or assignment of such lease will not disrupt substantially any tenant mix or balance in such shopping center.

* * *

(d)(1) In a case under chapter 7 of this title, if the trustee does not assume or reject an executory contract or unexpired lease of the debtor within 60 days after the order for relief, or within such additional time as the court, for cause, within such 60-day period, fixes, then such contract or lease is deemed rejected.

(2) In a case under chapter 9, 11, or 13 of this title, the trustee may assume or reject an executory contract or unexpired lease of the debtor at any time before the confirmation of a plan, but the court, on request of any party to such contract or lease, may order the trustee to determine within a specified period of time whether to assume or reject such contract or lease.

(e)(1) Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on--

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;

(B) the commencement of a case under this title; or

(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

* * *

> (f)(1) Except as provided in subsection (c) of this section, notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection.
>
> (2) The trustee may assign an executory contract or unexpired lease of the debtor only if--
>
>> (A) the trustee assumes such contract or lease in accordance with the provisions of this section; and
>> (B) adequate assurance of future performance by the assignee of such contract or lease is provided, whether or not there has been a default in such contract or lease.

Subsection (e)(1) makes the formerly employed termination clauses unenforceable. Subsections (b)(1) and (f) permit the trustee to assume or assign an unexpired lease subject to other provisions of this section. Subsection (b)(1)(C) and (f)(2)(B) require adequate assurances of future performance in the case of the assumption or assignment, respectively, of an unexpired lease. Subsection (b)(3) makes explicit what specific assurances of future performance are required in the case of a shopping center lease.

By these provisions, the right of a trustee to assume an unexpired shopping center lease under which there is an existing default is limited not only by the general provisions of subsection (b)(1), but also by the specific "shopping center" provisions of subsection (b)(3). The purpose of these provisions is to ensure that an unexpired shopping center lease is assumed by the trustee only where the trustee provides adequate assurance that there will be performance by the trustee under the debtor's lease in the future, and that that performance will include assurances of the source of rent, that the percentage rent due would not decline substantially (because of reduced sales), that the use provisions contained in any other lease, financing agreement or master agreement would not be substantially breached, and that the tenant mix would not be substantially disrupted.

That Congress intended to provide special protections for shopping centers and their solvent tenants regarding the assumption by a trustee of an unexpired lease is thus demonstrated not only by the language of these provisions, but also by their structure. Because of the concern about the ripple effect of a tenant bankruptcy, the shopping center industry is the only industry which Congress determined to protect with a specific provision, Section 365(b)(3).

An examination of the legislative history of these provisions explains and provides further support for the proposition that Congress intended to effectively prevent shopping centers and their solvent tenants from being unnecessarily injured in the event that one tenant became insolvent.

As introduced, section 365(b)(1) and (f)(2) of H.R. 8200 required that "adequate assurances" of future performance be provided the lessor in the case of either an assumption or assignment by a trustee of an unexpired lease. The shopping center industry argued that this requirement was too vague to effectively solve the problems which would be encountered by shopping centers in the event of the assumption or assignment of a lease.

The House Judiciary Committee responded to these arguments by including in its report the following language:

> The unenforceability of ipso facto or bankruptcy clauses proposed under this section will require the courts to be sensitive to the rights of the nondebtor party to executory contracts and unexpired leases. If the trustee is to assume a contract or lease, the courts will have to insure that the trustee's performance under the contract or lease gives the other contracting party the full benefit of his bargain. An example of the complexity that may arise in these situations and the need for a determination of all aspects of a particular executory contract or unexpired lease is the shopping center lease under which the debtor is a tenant in a shopping center.
>
> A shopping center is often a carefully planned enterprise, and though it consists of numerous individual tenants, the center is planned as a single unit, often subject to a master lease or financing agreement. Under these agreements, the tenant mix in a shopping center may be as important to the lessor as the actual promised rental payments, because certain mixes will attract higher patronage of the stores in the center, and thus a higher rental for the landlord from those stores that are subject to a percentage of gross receipts rental agreement. Thus, in order to assure a landlord of his bargained for exchange, the court would have to consider such factors as the nature of the business to be conducted by the trustee or his assignee, whether that business complies with the requirements of any master agreement, whether the kind of business proposed will generate gross sales in an amount such that the percentage rent specified in the lease is substantially the same as what would have been provided by the debtor, and whether the business proposed to be conducted would result in a breach of other clauses in master agreements relating, for example, to tenant mix and location.

H.R. Rep. No. 595, 95th Cong., 1st Sess., 348-349 (1977).

The Senate Judiciary Committee responded to these concerns by incorporating in S. 2266 the following language:

* * *

> (b)(3) The provisions of paragraph (1) of this subsection shall not prevent termination of a lease pursuant to provisions contained therein--
>
> (A) in a case under chapter 7 of this title;
> (B) where the lease was entered into before the effective date of this title;
> (C) where the property leased thereunder is not essential to the debtor's business;
> (D) where the rent payable pursuant to the lease is substantially less than the fair rental value of the property leased thereunder; or
> (E) where the lease contains provisions for rent contingent upon the lessee's profits or sales and the rent otherwise set forth in the lease was

> substantially less than the fair rental value of the property at the time the lease was entered into.
>
> * * *
>
> (b)(5) For purposes of this subsection, "adequate assurance" shall include with regard to an unexpired lease of the debtor reasonable assurance--
>
> (A) of the source of rental payments and other consideration due and owing to the landlord under the lease agreement;
> (B) that there will be no substantial decline in any percentage rates specified by the lease;
> (C) that the assignment or assumption of the lease will not substantially breach clauses (including, but not limited to, radius, location, use, and exclusive clauses) in other leases, financing agreements, or a master agreement relating to the leased and adjoining leased premises; and
> (D) that an assumption or assignment of a lease will not disrupt the tenant mix or balance in property subject to multiple individual leases and an overall master agreement.

Further, the Senate Committee made clear in its report that subsection (b)(5) was intended to assist shopping centers.

> Subsection (b)(5) provides that in lease situations common to shopping centers, protections must be provided for the lessor if the trustee assumes the lease, including protection against decline in percentage rents, breach of agreements with other tenants, and preservation of the tenant mix. Protection for tenant mix will not be required in the office building situation.

S. Rep. No. 989, 95th Cong., 2nd Sess., 59 (1978).

By agreement of the Senate and House floor managers of this legislation, a compromise bill was introduced which contained the language in subsection (b)(3) which was ultimately enacted.

In the Senate and House debates on the compromise bill, this provision was described as follows:

> Section 365(b)(3) represents a compromise between H.R. 8200 as passed by the House and the Senate amendment. The provision adopts standards contained in section 365(b)(5) of the Senate amendment to define adequate assurance of future performance of a lease of real property in a shopping center.

124 Cong. Rec. S17409 (daily ed., Oct. 6, 1978) (remarks of Sen. De Concini); 124 Cong. Rec. H11093 (daily ed, Sept. 28, 1978) (remarks of Mr. Edwards).

V. Problems Under the Code and Proposed Solutions

A. Substantive Amendments

1. Time Limit on Acceptance or Rejection of Lease

The 1978 Act presented landlords with a new problem by voiding lease clauses that terminated the tenancy on bankruptcy and by providing, in §365 of the Code, that the trustee may assume or reject the unexpired lease of the debtor. No time limit is imposed on this action. This has created serious problems for shopping centers when space has been either left vacant for an extended period of time without providing the landlord an opportunity to relet the premises to a new tenant or a store has operated at a minimum level.

Under the current law, the trustee can keep the landlord in this ambiguous position for several months. Frequently, the landlord is forced to make a payment to the trustee to extricate himself from this difficulty. As indicated above, other retailers in the center, as well as the landlord, suffer uncompensated losses during this period. Accordingly, the payment is not based on the value of the lease but is in the nature of ransom to save the rest of the center.

This problem is especially acute when the debtor was the anchor tenant which was intended to attract customers to the center and on which the other retailers relied for traffic. It is fundamental that a shopping center cannot function properly without a viable anchor tenant. In the event of its bankruptcy, it must either be revitalized promptly or replaced. An extended vacancy will destroy the center. Although the landlord has the right to file a motion to require the trustee to assume or reject the lease, this procedure requires so much time for completion that it frequently exacerbates the problem.

Section 365(d) of the Code should be amended to read as follows:

> "(d)(1) In a case under Chapter 7 of this title, if the trustee does not assume or reject an executory contract of the debtor within 60 days after the order for relief, or within such additional time as the court, for cause, within such 60-day period fixes, then such contract is deemed rejected.
>
> (2) In a case under chapter 9, 11, or 13 of this title, the trustee may assume or reject an executory contract of the debtor at any time before the confirmation of a plan, but the court, on request of any party to such contract, may order the trustee to determine within a specified period of time whether to assume or reject such contract.
>
> (3) In all cases under this title, if the trustee does not assume or reject an unexpired lease of the debtor within 60 days after the order for relief, or within such additional time as the court, for cause, within such 60-day period, fixes, then such lease is deemed rejected, and in the case of a lease of real property, the court shall order the premises to be vacated immediately."

2. Payment of Current Rent and Performance of Lease Obligations

Although rent during the period of administration of the estate is treated as an administrative expense, that does not constitute sufficient protection under the new law which permits the trustee to remain in possession of the premises for an extended period of time. This presents a hardship to a landlord who may not receive rent for several months and is unable to gain control of his premises. We are not aware of any other class of person who is required to provide a service to the bankrupt estate without current compensation.

Cases have permitted trustees to pay a warehouse value rent for space no longer being used for retail sales. This is grossly unfair to a landlord who has developed a shopping center for retail business and has obtained financing based on the stream of rents from retail rental use.

Similar considerations apply to the other obligations under the lease. Until the lease is rejected, the trustee should perform all obligations under the lease to prevent serious damage to the shopping center and the other tenants:

The following sentences should be added to §365(a):

> The trustee shall timely perform all the obligations of the tenant arising from and after the date of the order for relief, under an unexpired lease (including payment of the rent and other charges specified in such lease) until such lease is assumed or rejected, notwithstanding the provisions of §503 of this title. For cause shown, the court may extend the time for performance of any obligation of rent or other charges due upon an unexpired lease pursuant to the provisions of section 108(b) of this title. Acceptance of such performance shall not constitute a waiver or relinquishment of the lessor's rights under the lease or under this title.

3. Deletion of "substantially" Standard

The section inserted in the Code for the protection of shopping centers is §365(b)(3). While inclusion of the word "substantially" in subsection (B) of this section (requiring payment of percentage rent) may be appropriate because the law cannot guarantee a particular level of rent, the word "substantially" is not appropriate for subsections (C) and (D) (regarding the breach of other agreements and the disruption of the tenant mix). These are the critical provisions which are intended to assure that the business of the shopping center is preserved and the other tenants are not unduly injured by the bankruptcy proceedings. This requires that the specified clauses are not breached and that the tenant mix will not be disrupted by the action of the trustee. The use of the word "substantially" in these subsections inserts a major ambiguity into these critical provisions regarding how great a deviation will be allowed. This ambiguity has allowed some debtors to completely ignore the use clauses of their lease and advertise their space for "all retail uses." (See the attachment for an example.)

The word "substantially" should be deleted from §365(b)(3)(C) and (D) to avoid these kinds of problems.

4. Financial Status of New Tenant

Another problem presented by the Code's permitting the trustee to place a new tenant in a shopping center without the consent of the landlord is that the tenant, although solvent, may not be of the same financial quality as the landlord originally contracted for. This situation presents an exception to the fundamental principle of our law that businessmen are usually entitled to determine the persons with whom they wish to do business. If the trustee is going to assign the lease to a new tenant, that tenant should have the same financial standing as the original tenant had when the lease was signed.

The following language should be added to Section 365(b)(3)(A):

> ...and in the case of an assignment, with an operating and financial performance, including guarantors, similar to that of the original tenant when the lease was executed;

5. Security Deposits From New Tenants

If a landlord is required to accept a new tenant, then he is entitled to a security deposit in the same manner as is required from other tenants, and as utilities are allowed deposits under §366 of the Code.

A new subsection (1) should be added to §365 to read as follows:

> (1) If an unexpired lease is assigned pursuant to this section, the lessor of the property may require a deposit or other security for the performance of the obligations under the lease substantially the same as would have been required by the landlord upon the initial leasing to a similar tenant.

B. Technical Amendments

1. Assumption of Provisions of the Lease

Section 365(b)(3)(C) of the Code provides that a trustee, when assuming a lease of property in a shopping center, must provide adequate assurance that the assumption will not breach substantially specified provisions "in any other lease, financing agreement, or master agreement relating to such shopping center...." In at least two instances, trustees have taken the position that the requirement to comply with use clauses of all other leases implies that they do not have to comply with the use clause of the lease they are assuming. This would seem to be an erroneous interpretation of the law because §365(b)(1)(C) requires providing adequate assurance of future performance under the lease, and that ordinarily includes all of the terms and provisions of the lease.

In view of the difficulties which have been encountered, ICSC proposes that §365(b)(3)(C) of the Code be amended to read as follows:

> (C) that such assumption or assignment of such lease is subject to all the provisions thereof, including (but not limited) to provisions, such as a radius, location, use, or exclusivity provision, and would not breach any such provision contained in any other lease, financing agreement, or master agreement relating to such shopping center; and

2. Requirements for Assumption of Lease Regardless of Default

A technical problem exists in that Section 365(b)(3), the provision intended to protect shopping centers, applies only for "purposes of paragraph (1)," and that paragraph only applies "If there has been a default in an executory contract or unexpired lease of the debtor...". There is no justification for this limitation and the provisions of Section 365(b) (3) should apply to any assumption or assignment of a shopping center lease whether or not there has been a default.

The introductory language of Section 365(b)(3) should be amended to read as follows:

> (3) For purposes of paragraph (1) of this section and paragraph (2)(B) of section (f), adequate assurance of future performance of a lease of real property in a shopping center includes adequate assurance -

3. Termination of Leases Prior to Bankruptcy

It is desirable to clarify the Code to establish that leases terminated under state law, by their own terms or judicial action, prior to bankruptcy are not subject to the bankruptcy proceedings. This would avoid problems of resurrection of terminated agreements.

A new Section 365(c)(3) should be added to the Code to read as follows:

> (3) such contract or lease has been terminated under state law prior to the order for relief.

4. Termination of the Term of the Lease

It is possible that a lease will terminate by its own terms while the bankruptcy proceeding is still pending. It is possible to argue that the stay under §362 of the Code prevents a landlord from taking possession of the premises in accordance with a lease that has been terminated by expiration of the stated term.

A new subsection 2 should be added to §541(b) to read as follows:

> "and (2) any property subject to a lease which has expired by virtue of its own terms without regard to the bankruptcy proceedings. In the case of property subject to a lease which has expired by virtue of its own terms, the lessor shall be entitled to enforce its rights to possession of the property subject to such lease without further order of the court and notwithstanding the provisions of Section 362(a) of this title.

Attachments.

PROPOSED AMENDMENTS

A. BRIEF DESCRIPTION

The proposed amendments to Section 365 would accomplish the following:

1. Impose a 60 day limit on a trustee's acceptance or rejection of an unexpired lease in all bankruptcy cases, which may be extended for cause.

2. Require the trustee to perform all of the obligations of the tenant under the lease, including payment of rent and other charges specified in the lease, until the lease is assumed or rejected, unless the court extends the time for performance, for cause, up to 60 days after the petition is filed.
3. Delete the word "substantially" from the provisions requiring that an assignment of a shopping center lease would not breach other agreements and would not disrupt tenant mix.
4. Require the trustee to find that an assignee of a shopping center lease would have an operating and financial performance similar to that of the original tenant when the lease was executed.
5. Allow the lessor, in the event of a lease assignment, to require his customary security deposit from the new tenant.
6. Clarify existing Code language to make clear that under existing law any assignment of a lease is subject to all of the provisions of the lease being assigned as well as the provisions in any other relevant document, such as a financing agreement.
7. Clarify existing Code language to make clear that the special provisions for assignment of shopping center leases apply whether or not there has been a default under the lease.
8. Clarify existing Code language to make clear that leases that have been terminated under state law will not be treated as property of the debtor subject to bankruptcy and would not be subject to the administration of the bankruptcy court.

The proposed amendment to Section 541 would make clear that property subject to a lease which has expired by its own terms is not property of the estate and that a proceeding to obtain possession of such roperty is not automatically stayed by §362 of the Code.

B. Relevant Provisions, as Amended

§ 365. Executory contracts and unexpired leases

(a) Except as provided in sections 765 and 766 of this title and in subsections (b), (c), and (d) of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor. The trustee shall timely perform all the obligations of the tenant arising from and after the date of the order for relief, under an unexpired lease (including payment of the rent and other charges specified in such lease) until such lease is assumed or rejected, notwithstanding the provisions of §503 of this title. For cause shown, the court may extend the time for performance of any obligation of rent or other charges due upon an unexpired lease pursuant to the provisions of section 108(b) of this title. Acceptance of such performance shall not constitute a waiver or relinquishment of the lessor's rights under the lease or under this title.

(b)(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee--

(A) cures, or provides adequate assurance that the trustee will promptly cure, such default;

(B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and

(C) provides adequate assurance of future performance under such contract or lease.

(2) Paragraph (1) of this subsection does not apply to a default that is a breach of a provision relating to--

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;

(B) the commencement of a case under this title; or

(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

(3) For the purposes of paragraph (1) of this section and paragraph (2)(B) of section (f), adequate assurance of future performance of a lease of real property in a shopping center includes adequate assurance--

(A) of the source of rent and other consideration due under such lease[;] and in the case of an assignment, with an operating and financial performance including guarantors, similar to that of the original tenant when the lease was executed;

(B) that any percentage rent due under such lease will not decline substantially;

(C) that assumption or assignment of such lease is subject to all the provisions thereof, including (but not limited to) provisions such as a radius, location, use, or exclusivity provision, and will not breach (substantially) any such provision [, such as a radius, location, use, or exclusivity provision,] contained in any other lease, financing agreement, or master agreement relating to such shopping center; and

(D) that assumption or assignment of such lease will not disrupt [substantially] any tenant mix or balance in such shopping center.

(4) Notwithstanding any other provision of this section, if there has been a default in an unexpired lease of the debtor, other than a default of a kind specified in paragraph (2) of this subsection, the trustee may not require a lessor to provide services or supplies incidental to such lease before assumption of such lease unless the lessor is compensated under the terms of such lease for any services and supplies provided under such lease before assumption of such lease.

(c) The trustee may not assume or assign an executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if--

(1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and

(B) such party does not consent to such assumption or assignment; or

(2) such contract is a contract to make a loan, or extend other debt financing or financial accomodations, to or for the benefit of the debtor, or to issue a security of the debtor.

(3) such contract or lease has been terminated under state law prior to the order for relief.

(d)(1) In a case under Chapter 7 of this title, if the trustee does not assume or reject an executory contract [or unexpired lease] of the debtor within 60 days after the order for relief, or within such additional time as the court, for cause, within such 60-day period fixes, then such contract [or lease] is deemed rejected.

(2) In a case under chapter 9, 11, or 13 of this title, the trustee may assume or reject an executory contract [or unexpired lease] of the debtor at any time before the confirmation of a plan, but the court, on request of any party to such contract, may order the trustee to determine within a specified period of time whether to assume or reject such contract [or lease].

(3) In all cases under this title, if the trustee does not assume or reject an unexpired lease of the debtor within 60 days after the order for relief, or within such additional time as the court, for cause, within such 60-day period, fixes, then such lease is deemed rejected, and in the case of a lease of real property, the court shall order the premises to be vacated immediately."

* * *

(l) If an unexpired lease is assigned pursuant to this section, the lessor of the property may require a deposit or other security for the performance of the obligations under the lease substantially the same as would have been required by the landlord upon the initial leasing to a similar tenant.

Section 541. Property of the Estate.

* * *

(b) Property of the estate does not include: (1) any power that the debtor may only exercise solely for the benefit of an entity other than the debtor[.]; and (2) any property subject to a lease which has expired by virtue of its own terms without regard to the bankruptcy proceedings. In the case of property subject to a lease which has expired by virtue of its own terms, the lessor shall be entitled to enforce its rights to possession of the property subject to such lease without further order of the court and notwithstanding the provisions of Section362(a) of this title.

C. Side-by-Side Comparison of Present Law and Proposed Amendments

Present Law	Proposed Law
§ 365. Executory contracts and unexpired leases	§ 365. Executory contracts and unexpired leases
(a) Except as provided in sections 765 and 766 of this title and in subsections (b), (c), and (d) of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor.	(a) Except as provided in sections 765 and 766 of this title and in subsections (b), (c), and (d) of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor. The trustee shall timely perform all the obligations of the tenant arising from and after the date of the order for relief, under an unexpired lease (including payment of the rent and other charges specified in such lease) until such lease is assumed or rejected, notwithstanding the provisions of §503 of this title. For cause shown, the court may extend the time for performance of any obligation of rent or other charges due upon an unexpired lease pursuant to the provisions of section 108(b) of this title. Acceptance of such performance shall not constitute a waiver or relinquishment of the lessor's rights under the lease or under this title.
(b)(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee--	(b)(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee--
(A) cures, or provides adequate assurance that the trustee will promptly cure, such default;	(A) cures, or provides adequate assurance that the trustee will promptly cure, such default;
(B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and	(B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and
(C) provides adequate assurance of future performance under such contract or lease.	(C) provides adequate assurance of future performance under such contract or lease.
(2) Paragraph (1) of this subsection does not apply to a default that is a breach of a provision relating to--	(2) Paragraph (1) of this subsection does not apply to a default that is a breach of a provision relating to--

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;	(A) the insolvency or financial condition of the debtor at any time before the closing of the case;
(B) the commencement of a case under this title; or	(B) the commencement of a case under this title; or
(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.	(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.
(3) For the purposes of paragraph (1) of this section, adequate assurance of future performance of a lease of real property in a shopping center includes adequate assurance--	(3) For the purposes of paragraph (1) of this section and paragraph (2)(B) of section (f), adequate assurance of future performance of a lease of real property in a shopping center includes adequate assurance--
(A) of the source of rent and other consideration due under such lease;	(A) of the source of rent and other consideration due under such lease and in the case of an assignment, with an operating and financial performance, including guarantors, similar to that of the original tenant when the lease was executed;
(B) that any percentage rent due under such lease will not decline substantially;	(B) that any percentage rent due under such lease will not decline substantially;
(C) that assumption or assignment of such lease will not breach substantially any provision, such as a radius, location, use, or exclusivity provision, in any other lease, financing agreement, or master agreement relating to such shopping center; and	(C) that assumption or assignment of such lease is subject to all the provisions thereof, including (but not limited to) provisions such as a radius, location, use, or exclusivity provision, and will not breach any such provision contained in any other lease, financing agreement, or master agreement relating to such shopping center; and
(D) that assumption or assignment of such lease will not disrupt substantially any tenant mix or balance in such shopping center.	(D) that assumption or assignment of such lease will not disrupt any tenant mix or balance in such shopping center.
(4) Notwithstanding any other provision of this section, if there has been a default in an unexpired lease of the debtor, other than a default of a kind specified in paragraph (2) of this subsection, the trustee may not require a lessor to provide services or supplies incidential to such lease before assumption of such lease unless the lessor is compensated under the terms of such lease for any services and supplies provided under	(4) Notwithstanding any other provision of this section, if there has been a default in an unexpired lease of the debtor, other than a default of a kind specified in paragraph (2) of this subsection, the trustee may not require a lessor to provide services or supplies incidental to such lease before assumption of such lease unless the lessor is compensated under the terms of such lease for any services and supplies provided under such

such lease before assumption of such lease.

(c) The trustee may not assume or assign an executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if--

(1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and

(B) such party does not consent to such assumption or assignment; or

(2) such contract is a contract to make a loan, or extend other debt financing or financial accomodations, to or for the benefit of the debtor, or to issue a security of the debtor.

(d)(1) In a case under chapter 7 of this title, if the trustee does not assume or reject an executory contract or unexpired lease of the debtor within 60 days after the order for relief, or within such additional time as the court, for cause, within such 60-day period, fixes, then such contract or lease is deemed rejected.

lease before assumption of such lease.

(c) The trustee may not assume or assign an executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if--

(1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and

(B) such party does not consent to such assumption or assignment; or

(2) such contract is a contract to make a loan, or extend other debt financing or financial accomodations, to or for the benefit of the debtor, or to issue a security of the debtor.

(3) such contract or lease has been terminated under state law prior to the order for relief.

(d)(1) In a case under Chapter 7 of this title, if the trustee does not assume or reject an executory contract of the debtor within 60 days after the order for relief, or within such additional time as the court, for cause, within such 60-day period fixes, then such contract is deemed rejected.

(2) In a case under chapter 9, 11, or 13 of this title, the trustee may assume or reject an executory contract of the debtor at any time before the confirmation of a plan, but the court, on request of any party to such contract, may order the trustee to determine within a specified period of time whether to assume or reject such contract.

(3) In all cases under this title, if the trustee does not assume or reject an unexpired lease of the debtor within 60 days after the order for relief, or within such additional time as the court, for cause, within such 60-day period, fixes, then such lease is deemed rejected, and in the case of a lease of real property, the court shall

(2) In a case under chapter 9, 11, or 13 of this title, the trustee may assume or reject an executory contract or unexpired lease of the debtor at any time before the confirmation of a plan, but the court, on request of any party to such contract or lease, may order the trustee to determine within a specified period of time whether to assume or reject such contract or lease.

Section 541. Property of the Estate.

(b) Property of the estate does not include any power that the debtor may only exercise solely for the benefit of an entity other than the debtor.

order the premises to be vacated immediately."

(1) If an unexpired lease is assigned pursuant to this section, the lessor of the property may require a deposit or other security for the performance of the obligations under the lease substantially the same as would have been required by the landlord upon the initial leasing to a similar tenant.

(b) Property of the estate does not include: (1) any power that the debtor may only exercise solely for the benefit of an entity other than the debtor; and (2) any property subject to a lease which has expired by virtue of its own terms without regard to the bankruptcy proceedings. In the case of property subject to a lease which has expired by virtue of its own terms, the lessor shall be entitled to enforce its rights to possession of the property subject to such lease without further order of the court and notwithstanding the provisions of Section 362(a) of this title.

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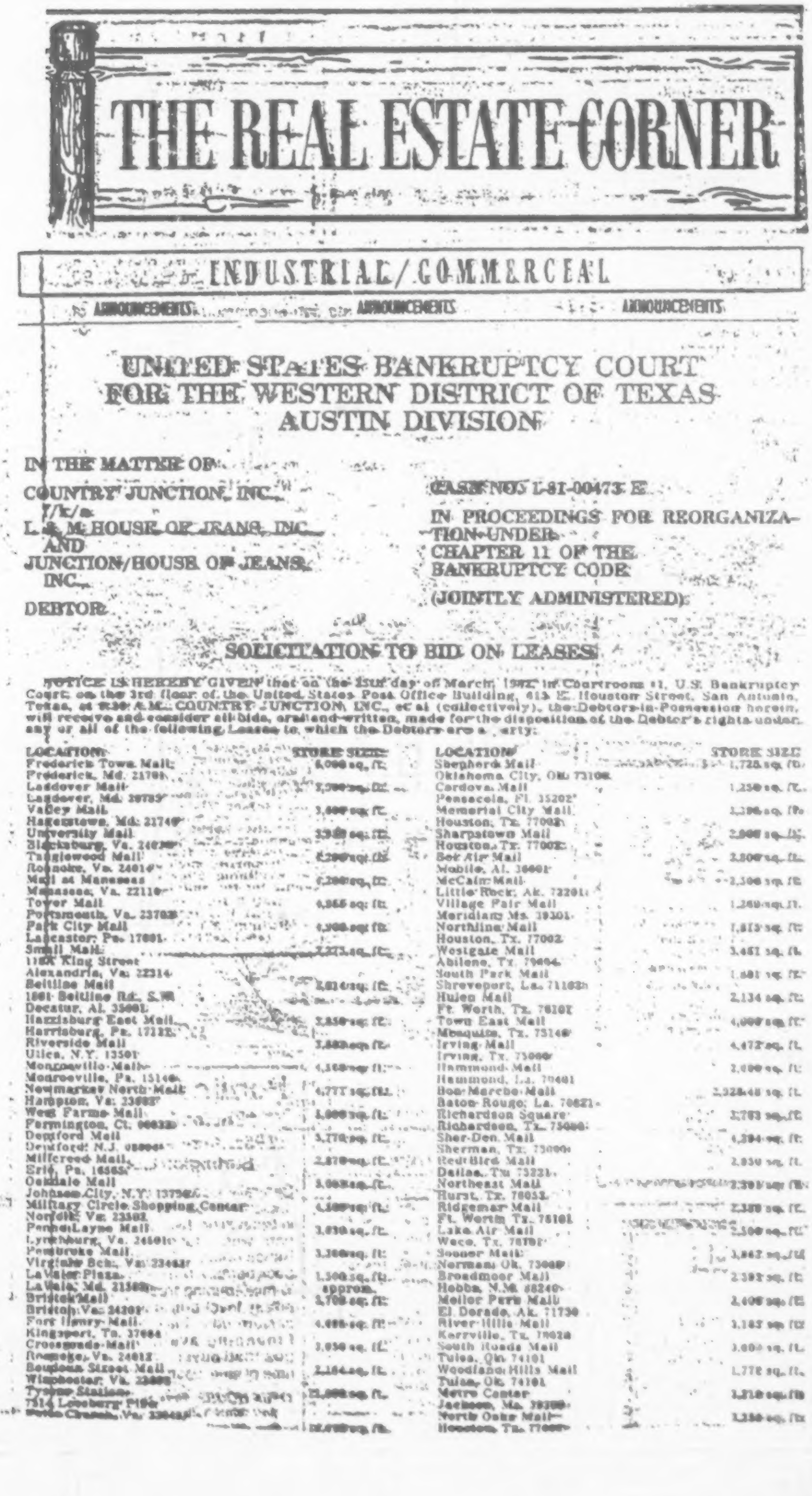

THE REAL ESTATE CORNER

INDUSTRIAL/COMMERCIAL

ANNOUNCEMENTS ANNOUNCEMENTS ANNOUNCEMENTS

UNITED STATES BANKRUPTCY COURT FOR THE WESTERN DISTRICT OF TEXAS AUSTIN DIVISION

IN THE MATTER OF
COUNTRY JUNCTION, INC.,
f/k/a
L & M HOUSE OF JEANS, INC.
AND
JUNCTION/HOUSE OF JEANS, INC.,
DEBTOR.

CASE NO. L-81-00473 E
IN PROCEEDINGS FOR REORGANIZATION UNDER
CHAPTER 11 OF THE BANKRUPTCY CODE
(JOINTLY ADMINISTERED)

SOLICITATION TO BID ON LEASES

NOTICE IS HEREBY GIVEN that on the 31st day of March, 1982, in Courtroom #1, U.S. Bankruptcy Court, on the 3rd floor of the United States Post Office Building, 615 E. Houston Street, San Antonio, Texas, at 9:30 A.M., COUNTRY JUNCTION, INC., et al (collectively), the Debtors-in-Possession herein, will receive and consider all bids, oral and written, made for the disposition of the Debtor's rights under any or all of the following Leases to which the Debtors are a party:

LOCATION	STORE SIZE	LOCATION	STORE SIZE
Frederick Towne Mall Frederick, Md. 21701	6,000 sq. ft.	Shepherd Mall Oklahoma City, Ok. 73107	1,725 sq. ft.
Landover Mall Landover, Md. 20785	[illegible] sq. ft.	Cordova Mall Pensacola, Fl. 35202	1,250 sq. ft.
Valley Mall Hagerstown, Md. 21740	3,600 sq. ft.	Memorial City Mall Houston, Tx. 77024	2,396 sq. ft.
University Mall Blacksburg, Va. 24060	[illegible] sq. ft.	Sharpstown Mall Houston, Tx. 77036	2,000 sq. ft.
Tanglewood Mall Roanoke, Va. 24014	6,200 sq. ft.	Bel Air Mall Mobile, Al. 36606	2,800 sq. ft.
Mall at Manassas Manassas, Va. 22110	6,200 sq. ft.	McCain Mall Little Rock, Ak. 72201	2,500 sq. ft.
Tower Mall Portsmouth, Va. 23703	4,865 sq. ft.	Village Fair Mall Meridian, Ms. 39301	1,260 sq. ft.
Park City Mall Lancaster, Pa. 17601	4,900 sq. ft.	Northline Mall Houston, Tx. 77022	1,813 sq. ft.
Small Mall 1101 King Street Alexandria, Va. 22314	2,273 sq. ft.	Westgate Mall Abilene, Tx. 79604	3,451 sq. ft.
Beltline Mall 1801 Beltline Rd. S.W. Decatur, Al. 35601	2,814 sq. ft.	South Park Mall Shreveport, La. 71108	1,881 sq. ft.
Harrisburg East Mall Harrisburg, Pa. 17111	2,850 sq. ft.	Hulen Mall Ft. Worth, Tx. 76132	2,134 sq. ft.
Riverside Mall Utica, N.Y. 13501	3,880 sq. ft.	Town East Mall Mesquite, Tx. 75149	4,000 sq. ft.
Monroeville Mall Monroeville, Pa. 15146	4,160 sq. ft.	Irving Mall Irving, Tx. 75060	4,472 sq. ft.
Newmarket North Mall Hampton, Va. 23666	4,777 sq. ft.	Hammond Mall Hammond, La. 70401	3,000 sq. ft.
West Farms Mall Farmington, Ct. 06032	5,000 sq. ft.	Bon Marche Mall Baton Rouge, La. 70821	2,328.48 sq. ft.
Deptford Mall Deptford, N.J. 08096	3,770 sq. ft.	Richardson Square Richardson, Tx. 75080	2,703 sq. ft.
Millcreek Mall Erie, Pa. 16565	2,870 sq. ft.	Sher-Den Mall Sherman, Tx. 75090	4,294 sq. ft.
Oakdale Mall Johnson City, N.Y. 13790	3,008 sq. ft.	Red Bird Mall Dallas, Tx. 75232	2,830 sq. ft.
Military Circle Shopping Center Norfolk, Va. 23502	4,100 sq. ft.	Northeast Mall Hurst, Tx. 76053	2,391 sq. ft.
Penne Layne Mall Lynchburg, Va. 24501	3,030 sq. ft.	Ridgmar Mall Ft. Worth, Tx. 76101	2,330 sq. ft.
Pembroke Mall Virginia Bch., Va. 23462	3,300 sq. ft.	Lake Air Mall Waco, Tx. 76710	2,500 sq. ft.
LaVale Plaza LaVale, Md. 21502	1,500 sq. ft. approx.	Sooner Mall Norman, Ok. 73069	3,862 sq. ft.
Bristol Mall Bristol, Va. 24201	3,700 sq. ft.	Broadmoor Mall Hobbs, N.M. 88240	2,393 sq. ft.
Fort Henry Mall Kingsport, Tn. 37664	4,000 sq. ft.	Mellor Park Mall El Dorado, Ak. 71730	2,400 sq. ft.
Crossroads Mall Roanoke, Va. 24012	3,050 sq. ft.	River Hills Mall Kerrville, Tx. 78028	3,183 sq. ft.
Loudoun Street Mall Winchester, Va. 22601	2,164 sq. ft.	South Roads Mall Tulsa, Ok. 74101	3,000 sq. ft.
Tysons Station 7514 Leesburg Pike Falls Church, Va. 22043	21,000 sq. ft.	Woodland Hills Mall Tulsa, Ok. 74101	1,778 sq. ft.
[illegible]	22,000 sq. ft.	Metro Center Jackson, Ms. 39209	3,210 sq. ft.
		North Oaks Mall Houston, Tx. 77060	3,250 sq. ft.

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Congressional Plaza 1606 Rockville Pike Rockville, Md. 20852	[illegible]	Greenville Mall Greenville, Ms. 38701	2,400 sq. ft.
Woodfield Commons Shopping Center 1258 East Golf Road Schaumburg, Ill. 60195	10,700 sq. ft.	Central Mall Lawton, Ok. 73501	4,200 sq. ft.
3855-A Peachtree Rd. N.E. Atlanta, Ga. 30319	10,500 sq. ft.	Big Town Mall Mesquite, Tx. 75149	3,738 sq. ft.
Old Keene Mill Shopping Center 5830-C Old Keene Mill Rd. Springfield, Va. 22152	3,600 sq. ft.	Forum 303 Mall Arlington, Tx. 76010	4,500 sq. ft.
Finley Square 1524 Butterfield Rd. Downers Grove, Ill. 60515	3,000 sq. ft.	Town City Mall Monroe, La. 71201	1,130 sq. ft.
Greenway Shopping Center 7483 Greenbelt Rd. Greenbelt, Md. 20770	10,000 sq. ft.	Indian Mall Jonesboro, Ak. 72401	3,400 sq. ft.
715 Southwest Military Dr. San Antonio, Tx. 78205	3,065 sq. ft.	Prestonwood Mall Dallas, Tx. 75201	3,188 sq. ft.
Westgate Mall Austin, Tx. 78701	2,500 sq. ft.	Golden Triangle Mall Denton, Tx. 76201	2,642 sq. ft.
Midtown Mall Killeen, Tx. 76541	3,000 sq. ft.	Sikes Center Wichita Falls, Tx. 76307	5,072 sq. ft.
Governor's Mall Tallahassee, Fl. 32303	1,600 sq. ft.	Crossroads Mall Oklahoma City, Ok. 73109	2,479 sq. ft.
Panama City Mall Panama City, Fl. 32405	[illegible] sq. ft.	Fayetteville Mall Fayetteville, Ak. 72701	2,544 sq. ft.
		Leigh Mall Columbus, Ms. 39701	1,750 sq. ft.
		North East Mall Hurst, Tx. 76053	1,227 sq. ft.
		Heartland Mall Brownwood, Tx. [illegible]	1,220 sq. ft.

FURTHER NOTICE IS HEREBY GIVEN THAT THE DISPOSITION OF ANY LEASE IS SUBJECT TO PRIOR AND SPECIFIC APPROVAL BY THE UNITED STATES BANKRUPTCY COURT FOR THE WESTERN DISTRICT OF TEXAS WHICH APPROVAL WILL BE SOUGHT UPON NOTICE TO THE AFFECTED LANDLORD AND PARTIES IN INTEREST AT A HEARING TO BE SCHEDULED BEFORE THE HONORABLE JOSEPH C. ELLIOTT, JUDGE, U.S. BANKRUPTCY COURT. Any objection made to the disposition of a particular Lease shall be heard by the Court at that time.

Interested persons may submit bids or request additional information for any or all of the Leases prior to March 25, 1982, by contacting Stone-East Associates, Inc., agent for the Debtors: Attention Dan S. Golinsky, 40 West 57th Street, New York, New York 10019, (212) 977-3100.

All offers are subject to the terms and conditions set forth below:

1. A deposit of the greater of (a) ten percent (10%) of the offering price or (b) $3,000.00 shall be made payable to the order of COUNTRY JUNCTION, INC., Debtor-in-Possession, upon the Debtor's oral acceptance of an offer, such deposit to be made by check subject to collection. Such acceptance is subject to court approval as described above. The balance of the offering price shall be paid by bank or certified check within three (3) business days of the entry of an order of the Bankruptcy Court approving the assumption and disposition of the Leases.

2. The successful bidder shall enter into a "Purchase Agreement for Leasehold Interest" (hereinafter the "Purchase Agreement") upon the Debtors' oral acceptance of an offer. The Purchase Agreement can be obtained from Stone-East Associates, Inc. The provisions of the Purchase Agreement shall constitute additional terms and conditions of disposition.

3. Except as otherwise provided in the Purchase Agreement, in the event that COUNTRY JUNCTION, INC. does not, for any or no reason, consummate the disposition transaction, its sole liability to the successful bidder shall be for the return of bidder's deposit.

4. The Debtors reserve the right to reject any bid or bids which in their discretion are deemed inadequate or insufficient or which are contrary to the best interests of the estates of the Debtors and their creditors.

5. The disposition of a Lease does not include the sale of fixtures and equipment unless otherwise stated on March 25, 1982.

6. Prior to the bidding on each Lease on March 25, 1982, further specific details may be announced, including the establishment of upset prices for particular Leases.

7. No disposition is final until a Court Order is signed by the Bankruptcy Judge after notice to the affected Landlord and other parties in interest and hearing.

8. All bidders acknowledge that they have had an opportunity to review the Purchase Agreement, the Leases and all other pertinent documents in the possession of the Debtors or their agents regarding the Leases prior to making their offers and are relying on such review and their own inspection of the leasehold property in making their offers.

9. All sales and transfer taxes, recording fees, etc., if any, related to the disposition of the Leases shall be the sole responsibility of the successful bidders and shall be paid to the Debtors or the appropriate agent which due.

10. Country Junction reserves the right to dispose of any Lease by private sale or otherwise prior to March 25, 1982.

NOTICE IS FURTHER GIVEN that the Debtors may, in their discretion, withdraw any of the above-referenced Leases from competitive bidding from time to time or may adjourn the consideration of bids thereof, without notice to creditors or other parties in interest, other than by announcement of such withdrawal or adjournment on the dates scheduled for hearing.

DATED: March 8, 1982.

ZISSU BERMAN HALPER BARRON & GUMBINGER
150 Park Avenue
New York, New York 10022
Att: Leo Fox, Esq.
(212) 593-1570
and
SCHENKER, ROSENHEIM & SCHENKER
1100 One Riverwalk Place
700 N. St. Mary's Street
San Antonio, Texas 78205
Att: Garvin P. Stryker, Esq.
(512) 224-1801
STONE-EAST ASSOCIATES, INC.
40 West 57 St.
New York, New York 10019
Att: Dan S. Golinsky, V.P.
(212) 977-3100

- Sample Lease Assignment Advertisement

THE WALL STREET JOURNAL
Friday, Marh 19, 1982

REAL ESTATE FOR SALE REAL ESTATE FOR SALE REAL ESTATE FOR SALE

BANKRUPTCY SALE MARCH 25, 1982

PRIME SPACE AVAILABLE IN QUALITY MALLS

COUNTRY JUNCTION, COUNTRY LEGEND AND HOUSE OF JEANS

- VARIOUS LEASEHOLD TERMS OF 1-10 YEARS
- 1500-5000 SQ. FT. AVAILABLE
- ALL RETAIL USES CONSIDERED
- STORES PREVIOUSLY TRADED AS:
  ZIPPERS, COUNTRY LEGEND, PANTS SOUTH, HOUSE OF JEANS, DEPOT, JUNCTION, THE JUNCTION, WESTERN JUNCTION, JEANS AND TOPS, JUNIOR JUNCTION.
- STORES LOCATED IN ENCLOSED REGIONAL MALLS:
  MARYLAND (6); VIRGINIA (14); PENN. (4); ALA. (1); N.Y. (2); CONN. (1); N.J. (1); TENN. (1); ILLINOIS (2); GEORGIA (1); TEXAS (31); FLA. (3); OKLAHOMA (6); ARK. (4); MISS. (4); LA. (5); N.M. (1).

BANKRUPTCY SALE WILL BE HELD MARCH 25, 1982 AT 9:00 AM IN COURTROOM NO. 1 OF THE U.S. BANKRUPTCY COURT, 3rd FLOOR, U.S. POST OFFICE BUILDING, 615 E. HOUSTON STREET, SAN ANTONIO, TEXAS.

FOR FURTHER INFORMATION CONTACT:
DAN S. GOLINSKY, V.P.

STONE-EAST ASSOCIATES, INC.
40 WEST 57 ST., NEW YORK, NY 10019 (212) 977-3100

PREPARED STATEMENT OF NATHAN B. FEINSTEIN

Personal

I am partner in charge of the Bankruptcy and Creditors' Rights Section of the Philadelphia law firm of Cohen, Shapiro, Polisher, Shiekman & Cohen. My firm represents a middle range of entrepreneurs and corporations, and substantial real estate development and financing interests. I have spent most of the last twenty-five years representing borrowers and lenders, offerrors of securities and their purchasers, landlords and tenants, and, more recently, debtors and creditors - hopefully not both at the same time. Although I am appearing before your SubCommittee on behalf of the International Council of Shopping Centers, I hope to bring a broad perspective to these hearings.

I testified before this subcommittee last year in support of the Shopping Center Protections Improvements Act of 1982, S. 2297. Last year, I was accompanied by another bankruptcy practitioner, Laurence D. Cherkis. We discussed the operation of the Bankruptcy Code provisions relating to the bankruptcy of a shopping center tenant and the changes which S. 2297 would have made in the Bankruptcy Code.

The purpose of my testimony today is to stress the continued need for the changes in the Bankruptcy Code which this legislation would make, and to explain why these changes are even more necessary today.

The three major changes in the Bankruptcy Code which would be made by this legislation are: 1) to require the trustee to decide whether to assume or reject a lease within 60 days after filing the petition for bankruptcy, unless the court extends that time for cause; 2) to require that until the lease is assumed or rejected the trustee must perform the obligations of the debtor under the lease, including the payment of rent; and 3) to require that in the event that a shopping center lease is assumed or assigned, any use restrictions in the lease will be strictly adhered to.

These changes are a necessary response to problems which have been experienced by shopping centers and their solvent tenants in the administration of bankruptcy cases under the Code.

None of the problems which were brought to the subcommittee's attention last year have been resolved. There have been no decisions by Courts of Appeals ameliorating these problems or removing the ambiguities in the Code which necessitated the several technical amendments contained in the bill last year.

This legislation is needed more this year than last. I testified last year that it usually taked between nine months and a year to get a determination concerning the assumption or rejection of a lease in a contested Chapter 11 case. This situation has not improved since I delivered that testimony. The delays involved in getting a determination on the assumption or rejection of a lease, or on almost any other significant issue, have increased, not only because of greater clogging of the bankruptcy courts caused by the increased number of bankruptcy filings, but because of the bifurcated jurisdiction (bankruptcy and district courts) problems inherent in the rules which now purport to deal with the Marathon problem.

If Congress resolves the Marathon problem by giving bankruptcy judges Article III status, there will be an additional reason for amending the Bankruptcy Code to solve these problems. Under the bankruptcy system in place prior to December 25, 1982, and today under the Judicial Conference's rules, interlocutory appeals of the decisions of bankruptcy judges could be taken by district court judges. Because the bankruptcy court is generally viewed as an inferior court by district court judges, the decisions of bankruptcy judges were subjected to some scrutiny and accorded less weight than if they had been decided by another district judge.

If bankruptcy judges are granted Article III status, their decisions will have more binding effect because reviewing courts will accord them greater deference. It will, therefore, become more important that ambiguities and other problems in the Bankruptcy Code be resolved by legislation.

General Effect of Amendments

The Proposed Amendments would require the tenant who is a Chapter 11 debtor to adhere as closely as is reasonable to the expectations of the parties who relied upon their lease agreements. If the trustee or Chapter 11 debtor intends to keep the leasing relationship in force, the amendments would require the tenant to perform the rental and other obligations under the lease. If the trustee or Chapter 11 debtor has not made up his mind whether to assume or reject the lease at the time he files his Chapter 11 Petition, the Amendments would require him to make that decision within 60 days. If the lease has terminated or if the trustee has determined to reject the lease, the amendments would require the Chapter 11 debtor to vacate the premises promptly. If the trustee or Chapter 11 debtor opts to sell or assign the lease to a new tenant, the Amendments would emphasize that the new tenant-assignee must be of similar financial standing and must undertake the same lease obligations as the original tenant.

The Shopping Center Perspective

I would be a mistake to view a shopping center solely as a real estate investment. In a real sense a shopping center is akin to a small town.

You put down a business root in a town if you believe you will fit in, you believe the town will provide security and other necessary services, and you believe the town will flourish, and your business with it. If the major businesses or other institutions that draw people to town shut their doors, the town will die. If the town's financial base shrinks, the security and other communal services will shrink, and with it will shrink the desirability of the town as a place to visit. If the neighbors with whom you are comfortable leave town, you will soon begin to look elsewhere.

Tenants locate in shopping centers based on the complimentary ability of the various stores in the shopping center to draw customers. One looks to the advertising and merchandising techniques of the larger stores ("anchor stores") in choosing a shopping center. One considers carefully the cooperative advertising, the center promotions, and the parking and other common services performed by the center. The shopping center and its tenants' association rely on a continuing stream of payments from tenant-shopkeepers to meet the snow removal, air conditioning, heating, parking lot maintenance, advertising, mortgage, tax and other obligations of the center. When the stream of payments is disrupted for a significant period of time, every shopowner suffers by the lack of maintenance and uncertain financial viability of the center. When an anchor store closes its doors and stops its advertisements, the smaller tenants suffer the lack of patronage. When Saks Fifth Avenue moves out as anchor store and John's Bargain moves in, the small independent fashion boutiques die. When the future of the center is in doubt, a businessman-tenant does not know how to order for the next season.

Proposed Amendments to §362(a) and 362(d)(1) Prompt Assumption or Rejection of Leases

The Proposed Amendment to Section 362(a) and the Amendment to Section 362(d)(1) restore a balance between the operating shopping center's needs for performance of a tenant's obligations while he remains a tenant and for a relatively prompt determination of whether the shopping center will have a tenant or a vacancy with which to cope, and the Chapter 11 debtor's need for time to make a decision.

In its present form, Section 365(a) of the Bankruptcy Code permits a Chapter 11 debtor to assume or reject an unexpired lease, but without a prescribed time limitation. Although current Section 365(d)(2) contemplates that a landlord may ask a court to order assumption or rejection in a reorganization proceeding "within a specified period of time", a Chapter 11 debtor is rarely required to make or give effect to that election earlier than six months after the bankruptcy petition has been filed. After receiving notice of the Chapter 11 petition (often several weeks after its filing), the landlord must prepare and file an application with the bankruptcy court, usually allow 20 days or so for a responsive pleading to be filed, at which point the matter is set for hearing (often 20 or 30 days after the responsive pleading in crowded jurisdictions). It is only then that the bankruptcy court will usually "order the trustee to determine within a specified period of time whether to assume or reject such contract or lease". It is a rare case for a bankruptcy court to direct that the decision be made earlier than 60 days following the issuance of its order. If the landlord's Application is contested and argued, the bankruptcy court may keep the matter under consideration pending an opinion or decision for weeks or months before the order to assume or reject is issued. If the Chapter 11 debtor ("the trustee") then determines to reject the lease, the rejection decision must go back to the bankruptcy court for the court's approval (Section 365(a) specifically requires that the trustee's determination to either assume or reject a lease is "subject to the court's approval", thus requiring additional court action, and a hearing if requested by "any party in interest", before the trustee's election to assume or reject becomes effective). Even then, a court-approved rejection is not tantamount to the tenant's vacation of the premises. Bankruptcy courts have regularly allowed a Chapter 11 debtor who has rejected a lease to remain in the premises for the month or two following the effective date of the rejection to allow time for the debtor to advertise a bankruptcy sale of the goods or fixtures on the premises. In many jurisdictions there is yet an additional delay until a report of the bankruptcy sale has been delivered to the bankruptcy court and court approval secured. I repeat, it is a rare case where an actual vacation of the premises can be secured within six months of the filing of a Chapter 11 petition, and longer delays are common.

The Proposed Amendment would change Section 365(d) of the current Bankruptcy Code to require that the debtor make a decision respecting the assumption or rejection of executory leases within 60 days after the proceedings have been initiated. Currently the requirement exists only "in a case under Chapter 7". The Proposed Amendment would make the requirement applicable to leases "in all cases under this title". The requirement to make a decision within 60 days would not be absolute. A trustee or debtor in possession may ask the court for "such additional time as the court, for cause, within such 60-day period, fixes." If the trustee does not act to assume or ask for additional time during the 60 day period, then the lease is deemed rejected. That puts the shopping center in a position to begin seeking a replacement tenant within a reasonable time after the Chapter 11 debtor has elected to seek the protection of the bankruptcy court.

The Amendment to Section 365(a) would require the timely performance of tenant obligations under an unexpired lease between the time the Chapter 11 case has commenced and the date of assumption or rejection. The second sentence of that Amendment permits the Court to extend the time for performance, for cause, up to sixty (60) days after the Petition is filed. The third sentence of the proposed amendment to Section 365(d)(1) merely provides that the landlord's acceptance of rental payments or other lease performance following a rejection of the lease and order of vacation will not be deemed an acquiescence by the landlord to the continuation of the lease. There have been a number of bankruptcy court decisions in the past (and there are similar decisions in some states) that acceptance by a landlord of a rental payment after the lease has otherwise been terminated or violated may constitute a waiver of the termination. This sentence merely assures that acceptance of the payments required to be made under the Proposed Amendments to Section 365(a) will not take away what the amendments are designed to provide.

As described above, it is a rare case today in which assumption or rejection of a lease is required in a Chapter 11 case earlier than six months or so after the case begins. Even upon the adoption of the proposed amendment to Section 365(d), it is apparent that 90 days or more will be entailed before a vacation of the premises is effected, and the bankruptcy courts may upon an application by the debtor in possession allow substantial additional times to run. The Proposed Amendment to Section 365(a) simply requires that the Chapter 11 debtor "timely perform" its obligations during that period.

Most shopping center leases require tenants to pay their share of common area maintenance (security, snow removal, heating or air conditioning an enclosed mall), taxes, rents, and the like. It is obvious that if the tenant opts to remain in possession of the premises, he should at least promptly pay the current lease obligations. The shopping center itself cannot refuse to pay taxes or mortgage obligations, the tenants association cannot refuse to remove snow or provide security, and there is no valid reason that the Chapter 11 debtor who elects to remain in the premises should not perform like obligations.

The matter becomes far more crucial when the Chapter 11 debtor is an "anchor store". Many of the major Chapter 11 cases in recent years have involved anchor stores. Food Fair, W. T. Grant and City Stores may be cited as examples. Those anchor stores had been looked to as primary draws of clientele to the entire shopping center. The smaller tenants in the shopping center had generally determined to locate in that center based upon the nature of the anchor store. It is apparent that the dry cleaning establishment located next to a food supermarket depends on the continued operation of the food market to draw customers. A shoe store or fashion boutique depends upon the advertising and continued operation of the Saks or Marshall Fields department store (or some prompt substitute) for its continued viability. In recognition of the importance of the anchor store, the operators of such locations have long been able to negotiate far more favorable terms for their tenancy than have the smaller tenants. That is a simple economic recognition of the importance of the anchor store. In many instances the anchor store undertakes to perform specific services such as snow removal or lighting a major area of the shopping center in exchange for rental concessions in the lease. A hotly negotiated clause in almost any lease is the so-called "operations clause", generally requiring a tenant to remain open during the usual business hours at a shopping center. This is a simple recognition of the communal relationship in many or most shopping centers.

When an anchor store closes its doors or fails to perform its other obligations under a shopping center lease, it causes disaster to the other tenants in the shopping center, to say nothing of the shopping center operator. That condition is exacerbated when the anchor tenant refuses to vacate the premises, or even refuses to indicate its future intention to assume or reject the lease. The small solvent business tenant is then faced with the problem of not knowing what it should order as inventory for the ensuing seasonal periods because it is unable to assess the drawing power of the shopping center during the next several months; indeed, if the snow is not going to be removed or if the lack of anchor store payments will result in an inability of the tenants' association to pay for other services at the shopping center, the effect can be readily calculated. The Proposed Amendments would simply require that if a Chapter 11 debtor elects to remain in the premises, he shall continue to perform the lease obligations promptly.

The last clause in the first sentence of the Proposed Amendment to Section 365(a) cross-referring to Section 503 of the Code, merely serves to emphasize the ineffectiveness of the current Bankruptcy Code "remedy" designed to insure the meeting of "administrative expense" obligations. Section 503 incorporates the delay problem of requiring an attorney to file an application and attend a hearing before one can even secure an order for payment of an administrative expense, like post-petition rent. Nothing in Section 503 requires the payment of administrative expenses prior to confirmation (and indeed consummation) of a Chapter 11 Plan. That may and often does involve a delay of years, even where it is clear that the estate has and will have sufficient assets to pay for costs of administration. Furthermore, a number of courts have held that no interest is payable by the bankruptcy estate which delays in the payment of those expenses. In at least one notorious case, costs of administration were not paid for five years, while the estate invested almost $10,000,000 at interest rates close to 20% per annum, thus effectively creating a multi-million dollar fund for the payment of inferior creditor claims by the simple device of utilizing funds due for administration payments for the benefit of non-administration class creditors.

Proposed Amendments to Section 368(b)(3) and Section 365(1). Lease Assignments

The Proposed Amendment to Section 365(b)(3) and the Proposed Amendment to Section 365(1) focus on the problem of a lease assignment by the Chapter 11 debtor. It should be remembered that these Sections do not come into play where a lease itself permits unfettered assignment by the tenant, or where the proposed assignment is agreeable to the shopping center landlord. This comes into play, therefore, only where the lease itself specifically prohibits the assignment, or conditions the assignment to the landlord's consent, and the landlord opposes the assignment. In the original enactment of Section 365(b)(3) of the Bankruptcy Code, Congress evidenced its comprehension that shopping center mix and financial continuity posed unique problems. Notwithstanding the broad "adequate assurance" provisions designed by Congress, many lawyers have experienced a constant narrowing of that intention by bankruptcy courts. These provisions are designed to make the Congressional intent clear, and to amplify that intent based on recent experiences.

The Proposed Amendment to Section 365(b)(3)(A) indicates that when Congress was insisting on the adequate assurance of the post-assignment rent stream, it meant assurances similar to those contemplated by the original parties to the lease when they entered into the lease. There have been those who have expressed the view that the "adequate assurance" to which the landlord was entitled is simply replacement by a tenant of a financial standing similar to the original tenant immediately preceding the filing of the bankruptcy petition-an insolvent for an insolvent! The proposed amendment would make clear that if there is to be an assignment contrary to the landlord's will and contrary to the lease provisions, it must at least be to an assignee similar to the original tenant. If the original had a "triple A credit rating," the substituted tenant should have a similar rating. If the original tenant was an under-funded subsidiary corporation, but whose obligation was guaranteed by a highly rated parent, the proposed assignee should meet a similar standard.

Mortgage instruments covering shopping centers regularly provide that the tenants meet certain financial standards, and particularly that the anchor stores be of high standing. Often it is an event of default for the landlord to allow a tenancy which does not meet those standards. Unless the lease assignee is of a financial standing and operating performance similar to the original tenant, the landlord runs the risk of having a mortgage default imposed upon him by the assignment.

A greater problem, of course, is the effect on the value of the shopping center. The ability of a shopping center owner to resell the shopping center is almost always directly proportionate to the solidity and financial standing of the shopping center tenants. A shopping center with "triple A" anchor stores and a relatively solid rent stream would normally have a high value. If one substitutes an anchor tenant of inferior financial standing, the resale value of the shopping center (or its ability to re-finance) drops dramatically. That amounts to a clear taking of part of the value of the investor's interest in the shopping center without compensation.

The proposed amendment to subparagraph (c) of Section 362(b)(3) similarly carry forward what is believed to be the intention of Congress in the enacting the current Bankruptcy code provision.

As a technical matter, the proposed re-wording makes clear that the assumption or assignment will require compliance with the provisions of the assigned lease, as well as with similar provisions contained in other shopping center leases and agreements. It is possible to read the current language of Section 365(b)(3)(c) as requiring compliance with other leases and instruments, but not necessarily with the lease being assigned.

Of greater significance is the deletion of the "breach substantially" language of the current code provision.

The most significant of the provisions dealt with in subsection (c) are the "use or exclusivity" provisions. They are almost always carefully drawn and extensively negotiated. More important, they are relied upon by other tenants in the shopping center. If the use provision provides for use by a french restaurant serving haute cuisine, the lease almost certainly intended what it said and others have relied on that assurance. The Italian restaurant next store, or the ice cream parlor serving french ice cream is hardly mollified when the bankruptcy court permits the lease to be assigned to an assignee intending the latter uses. That danger exists even though the Bankruptcy Court finds that use by an assignee Italian restaurant or a french ice cream parlor would not "substantially breach" the lease between the landlord and the french restaurant tenant who has now become a Chapter 11 debtor and wishes (over the landlord's objection) to assign his lease.

A more important illustration involves assignment of the lease of an anchor store. Consider a shopping center such as the Watertower Shopping Center in Chicago, Illinois, which has as its anchor stores a Marshall Fields Department Store and a Lord & Taylor Department Store. The character of that shopping center is established by those stores as a "high end" shopping center, attractive to smaller boutiques, relatively expensive men's clothing stores, fashion shoe stores and similar uses. Depending on the character of the anchor stores, the other tenants have entered into long term leases. Consider what happens if one or both of those anchor stores file Chapter 11 proceedings, and the leases are assigned to John's Bargain Basement and J.C. Penney or Sears. This is not to suggest that the latter are not fine department store tenants. It is to make clear that they are department stores with a dramatically different appeal than Lord & Taylor or Marshall Fields. The proposed amendment is designed to eliminate the ability of the Bankruptcy Court - which may have an interest in increasing the resale values of leases "for the benefit of creditors" - from varying the agreed restrictions on use or exclusivity freely negotiated by the original landlord and tenant.

Proposed Amendments to Sections 365(c)(3) and 541 (b). The Terminated Lease Problem

The Proposed Amendments to Section 365(c)(3) and the Proposed Amendment to Section 541(b) deal with the terminated lease problem.

Where a lease has terminated prior to bankruptcy (either because the 10 or 20 year term has expired or because there has been a breach and timely notice of termination), or where after the filing of a Chapter 11 petition the lease has terminated"by virtue of its own terms without regard to the bankruptcy proceedings" (say, because the 10 year term expired a month after the Chapter 11 petition was filed) the business man's expectation is that the landlord-tenant relationship is at an end. This has proven not to be the case.[1] Courts (or trustees) have interpreted the stay provisions of Section

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[1] See, for Example In re A.L.S., Inc., 1 CBC 2d 516

362(a) of the Bankruptcy Code as inhibiting the landlord from taking immediate possession of the premises even after expiration of the lease, provided possession of the premises was not transferred prior to the filing of the bankruptcy petition.

The Proposed Amendments are simply an attempt to make clear that a lease which expires after bankruptcy by the lease terms itself, or terminates prior to bankruptcy by whatever action or lease terms are appropriate under state law, is indeed terminated.

Consider this example. Many long term leases provide for some extension or renewal option if the option is exercised three months or six months prior to the expiration of the ten or twenty year term. When that option date passes without exercise, the landlord begins immediately to seek a replacement tenant on the assumption that the premises will be available at the end of the lease term. Indeed, where there is an active and successful shopping center, the landlord will generally have entered into a lease contract with the replacement tenant prior to the actual termination of the earlier lease (but after option or renewal exercise date) so that there will be no vacancy in the shopping center. The tenant is happy to enter into such a lease even though the premises are not immediately available, because he can order his goods and fixtures and other operating requirements long in advance for delivery on his expected occupancy date. If the tenant under the expired lease can by virtue of filing a Chapter 11 petition hold up the delivery of occupancy, he thwarts the expectations of the parties, without having any real legal or equitable interest in the premises, other than the staying power given him by a bankruptcy court or the Bankruptcy Code. It is respectfully submitted that Congress never intended this result. These two amendments would make clear than when a lease has come to an end prior to bankruptcy or by its own terms, the lease is indeed at an end.

Conclusion

Judicial enforcement of agreements is the heart of a free enterprise system. Our society is characterized by businessmen agreeing to buy and sell, to borrow and repay, to lease and occupy; agreements reached by hard bargaining. It is the free determination of "from whom will I buy and what price", and "to whom will I sell under what terms" that undergirds what we call Freedom of Contract. "No...Law impairing the Obligation of Contracts" emerges early in any study of the American judicial, political or economic system.

Chapter 11 turns all of that on its head. A businessman finds that his source of supply has suddenly ceased. A shopping center tenant who entered into a long term lease relying on the May Company Department Store or Food Fair Super-Market advertising to draw customers to the shopping center, finds that reliance misplaced. The shopping center tenants' association that counted on monthly payments from the members of the association to pay for security, snow removal, parking lot maintenance and other critical services finds that it must suddenly cut back on those required functions. A landlord who undertook financial obligations based upon solemnized leases finds that his income stream has partly terminated and that he is unable to meet his tax and mortgage commitments. Were it not for Article I Section 8 of the Constitution, almost all would concur that much of the Bankruptcy Code was unconstitutional (and parts may well be).

The Proposed Amendments would require a shopping center business tenant which invokes the protection of Chapter 11 to act promptly so that its contractual relationship with the other businesses and with the mutually dependent obligations of the shopping center may be clarified.

The debtor usually has the opportunity to carefully plan invocation of a Chapter 11 proceeding. Rarely does a financial crisis occur overnight. The debtor, better than all the world, knows of his growing financial stringency. The words "we'll file a petition" emerge early in negotiations after a bank sends a "demand letter" or a landlord institutes action to collect unpaid rentals. Such litigation or negotiations are always conducted in the shadow of a Chapter 11 filing. The common experience among lawyers is that a Chapter 11 petition is generally filed after negotiations have broken down or is filed between the time a state court has entered a judgment and eviction or other execution on the judgment has occurred. To the well-counseled business-man in financial difficulties, Chapter 11 is merely one of the alternative tools for dealing with his difficulty. At the time a well-counseled Chapter 11 is filed, the debtor has some idea of the potential source of the funds which will be utilized to effect his Chapter 11 proceeding. For example, the principal shareholders or their friends will have agreed to advance funds to implement the reorganization provided the debts of the business can be scaled down. Unless there is an availability of funding, or assets which can be sold to produce funds, or a similar basis for infusing capital, a Chapter 11 proceeding is little more than a prelude to the ensuing Chapter 7 liquidation: a prelude during which the debtor's officers, favored suppliers, legal and financial advisors, and occasionally secured parties (particularly where the secured loans have been personally guaranteed by officers or shareholders) will be paid for current services.

This is not to be critical of either Chapter 11 or of those debtors who seek to utilize that available tool. It is simply to suggest that Chapter 11 is a legally available tool, and should be viewed in the context of one of the debtor's available tools to oppose the creditor's or landlord's legally available litigation, judgment execution, and debt foreclosure tools.

The point is that tenants and landlords have legitimate expectations regarding their mutual lease obligations. This mutuality becomes crucial in a multiple tenant shopping center. The Proposed Amendments are designed to limit the adverse impact of a Chapter 11 filing on the solvent tenants in a shopping center.

PREPARED STATEMENT OF JOHN S. HOLMES, SR.

My name is John S. Holmes, Sr. I am the President of the Merchants Association of the Frederick Shopping Center, located in Frederick, Maryland. I own a store in that shopping center which sells delicatessen food and beverages. The Frederick Shopping center is an unenclosed "strip center" of approximately 25 stores. Most of these businesses are locally owned and family operated. The Frederick Shopping Center merchants are entrepreneurs who have joined together in this shopping center to promote their common interests.

As President of its Merchants Association, I am aware of the problems and concerns of all of the merchants doing business in the shopping center. I have operated my store in the shopping center for 22 years, and I have been President of the Merchants Association for 11 of those years. In all this time, the most serious problem that our shopping center ever encountered was the bankruptcy and closing of two stores. One of these stores was a Food Fair grocery store which occupied a central location in the shopping center and provided the major drawing power to the shopping center. The other store was an automotive parts and service establishment.

Last year I testified in support of The Shopping Center Protections Improvements Act of 1982, S. 2297. In my testimony last year I explained that the sales revenues of the other tenants of the Frederick Shopping Center were reduced by up to 28 percent by the closing of these stores and the inability of the shopping center to re-lease this space to operating businesses for an extended period of time. I encouraged the Subcommittee to amend the Bankruptcy Code as proposed in S. 2297 to lessen these problems in the future.

Recently, another anchor store in the shopping center closed, but did not institute bankruptcy proceedings. The shopping center landlord was able to rapidly re-lease the space to a business contributing to the tenant mix. The purpose of my testimony today is to contrast the dramatic negative impact on the shopping center and its solvent tenants last year caused by the closing of a store in a bankruptcy proceeding, to the smooth transition from one major tenant to another this year when an anchor tenant went out of business but was not involved in a bankruptcy proceeding.

The Closing of a Major Tenant Not in Bankruptcy in 1983

One of the major tenants in the Frederick Shopping Center is a Woolco Department Store. As you may know, the Woolco stores recently went out of business, but without declaring bankruptcy. The Woolco store in the Frederick Shopping Center closed its doors two weeks ago. The Woolco store was an anchor tenant and the only clothing store in the shopping center. As such, it drew a substantial amount of customer traffic to the shopping center. This type of a store is necessary in a shopping center to provide a tenant mix which will attract the volume of customers sufficient to support the business of the other tenants.

Because Woolco was not in bankruptcy, the landlord was able to exercise his right under the lease to terminate the lease when the tenant ceased operations and the landlord had found a replacement tenant. Because the landlord profits from the volume of business in the center and because he wanted to ensure the continued viability of the shopping center by protecting the other tenants from the serious economic loss that would result from the lack of an important anchor tenant like Woolco, the landlord was highly motivated to find an appropriate substitute tenant ready to take over the space as soon as Woolco vacated it.

In fact, Samuel J. Rosenfeld, the owner of the shopping center, was able to find a replacement department store tenant for the space even before the Woolco store closed. I understand that a lease will be signed early next week with Murphy's, a store quite similar to Woolco. Murphy's is a large, well-run operation with over 100 stores. Needless to say, all of the existing tenants are gratified and relieved at the news of the Murphy's lease, and believe that it will be a valuable tenant in our shopping center. Because of the prompt action of the shopping center owner, as soon as the Woolco space can be renovated, it will be reopened and there will be a minimum of damage done to the other tenants in the shopping center.

As this case indicates, the ability of the landlord to quickly find a replacement tenant in the same business as the tenant going out of business is crucial to the well-being of the other tenants in a shopping center with a store closure. Before Woolco closed the other tenants knew that a replacement tenant had been located, what the business of the replacement tenant was, and when the replacement tenant would be operating. This enabled us to order goods for our stores accordingly.

As we learned to our regret last year, in a bankruptcy situation the uncertainty surrounding the identity and timing of a replacement tenant makes it very difficult for the other tenants to estimate what their sales will be in the future. Therefore it is difficult to determine what amount of goods should be ordered and how many employees will be needed to carry on the business of the store.

The three weeks that will elapse between the closing of the Woolco store and the signing of the lease with Murphy's stands in sharp contrast to the nine month delay in securing a replacement tenant which the shopping center experienced last year when the store closures were administered under the Bankruptcy Code.

BANKRUPTCIES IN THE FREDERICK SHOPPING CENTER IN 1980-1982

The experience of the shopping center in finding a replacement for the Woolco store stands in sharp contrast to the unhappy experience of the shopping center in dealing with two bankruptcies last year.

In early 1980, an automotive service establishment called Joe The Motorist filed for bankruptcy under chapter 11. This store continued to operate under chapter 11 until June 30, 1981. After terminating operations and boarding up its premises, this tenant attempted for several months to assign its lease to another business. Joe the Motorist was unsuccessful in this attempt and rejected the lease in March, 1982. Because of the uncertainty as to whether or not the lease would be assigned, it was not possible for the shopping center to begin serious negotiations with another tenant until the lease was rejected. During the period prior to the rejection I talked to two persons who were interested in leasing that space at that time, but who could not wait until the uncertainty regarding the lease was cleared up to lease it. It was not until months later in April that another tenant was located and operations resumed in Joe the Motorist's location.

A Food Fair grocery store was a major store in the Frederick Shopping Center in 1981. This store was in a central location in the shopping center, and it provided the primary drawing power for all of the other tenants in the center. On July 31, 1981, the Food Fair store in the Frederick Shopping Center closed as the result of a bankruptcy proceeding. In September of 1981, Food Fair assigned its lease to another grocery store, Farm Fresh. Four and one half months after Food Fair closed, Farm Fresh opened for business on November 18, 1981.

In the case of Joe the Motorist, the shopping center tried to regain control of the lease so that the space could be re-leased to an operating business, but it was unable to do so. In the Food Fair situation, the shopping center also was unable to regain the lease. Fortunately for the shopping center, Food Fair succeeded in assigning its lease to another grocery store approximately two months after closing. However, during this four and one half month delay there was serious economic damage done to the other tenants in the shopping center.

I understand that much longer delays in reopening a closed store have been experienced in other shopping centers. If that is the case, I have difficulty understanding how other tenants in those centers survived. The business of many of the merchants in our shopping center was severely damaged during the comparatively short time the Food Fair store was closed, and for many months thereafter.

IMPACT ON OTHER TENANTS OF MAJOR STORE CLOSINGS

In May of 1982, several months after the Food Fair store location had been reopened as Farm Fresh and after the replacement tenant for Joe the Motorist had opened, I talked to many of the other merchants in the Frederick Shopping Center about the impact the store closings had on their business. Every merchant with whom I spoke suffered a decrease in sales revenues over the period of the closings. For example, Kilbey's Appliances, which is next to the Food Fair store location, suffered a sales drop of 28 percent. The Horn and Horn restaurant suffered a 26 percent reduction in sales. May's Hardware Store, Olin Mills, Sherwin-Williams Paints, Woolworth's, Peoples Drug Store and the barber shop had sales reductions ranging from 20 to 25 percent. Sales in my store decreased 18 percent over that period.

It is important to understand what sales reductions of this magnitude mean in human terms. They mean that people's jobs are in danger. Our center was fortunate in that new stores resumed operations before it was necessary to lay-off our employees, but if that had not been the case it is clear that we would have been required to do so.

For some of the stores in the shopping center, sales were just beginning to return to the levels that existed prior to the store closings when I talked to them. Since that time, the sales of the other stores in the shopping center have generally returned to their pre-bankruptcy closings level. Because sales have returned to previous levels, we do not believe that the 1982 sales reductions discussed above were caused by the recession.

We believe that we were fortunate that our business has returned to its previous levels. The closing of a major store (such as a Food Fair or a Woolco) in a shopping center forces customers to go to other locations. It is natural that once customers go to another shopping center to purchase groceries at its food market they will make purchases from other merchants in that center. When the closing of a major store forces a shift of patronage to another center for a prolonged period of time, customers change their buying "traffic" patterns in other stores as well. New relationships are established with the merchants in the other shopping center and in some cases the shift in patronage will be permanent. In our case, it appears that most of our customers have come back, but it took time and a lot of work to get them back. Contrast this experience under the bankruptcy code with that we are having this year where the closing is not involved in a bankruptcy..

The closure of the Woolco store this year is not expected to harm the other tenants in the shopping center as did the closure of the two stores last year in the bankruptcy proceedings. This year we will be able to tell our customers when a replacement store will be opening and what kind of store it will be. Hopefully, most of our customers will not establish permanent relationships with merchants in other shopping centers, because they will know that they again will be able to satisfy all of their shopping needs in our center within a short period of time.

Because the landlord, rather than a bankruptcy trustee or a real estate broker, is selecting the replacement tenant, the motivation has been very strong to select a tenant which is in sound financial shape and is unlikely to expose the shopping center and its other tenants to the problems of another store closure. Also, because of his concern for tenant mix and his share of the sales, the landlord has selected a tenant with an operating performance similar to that of the Woolco store. As a result, the shopping center and the other tenants will receive the same benefits they received from the operation of the Woolco store.

NEED A PROPER BALANCE BETWEEN THE INTERESTS OF THE BANKRUPT TENANT, THE OTHER TENANTS, AND SOCIETY

As a shopping center tenant, I have a strong interest in Bankruptcy Code provisions which would enable me to reorganize my business if the need arose. Where tenants in our mall, such as Joe The Motorist, have continued to operate their store under chapter 11, the other tenants have not been significantly injured. However, when a tenant closes his store with no intention, or no prospect of reopening it, the other tenants and the economy are harmed to an extent far greater than any benefit which accrues from continuing to protect the bankrupt tenant. As a result, society as a whole is forced to pay the price of increased unemployment, reduced tax receipts, and reduced economic activity.

Although I understand that in some cases the assignment of a shopping center lease is a valuable asset of the debtor's estate, I believe it is improper for a bankrupt tenant to use the fact of his store's closing and the negative impact of that closing on the other tenants to his advantage.

All of the members of the Frederick Shopping Center Merchants Association understand that they may one day need the protection of the Bankruptcy Code. However, they are acutely aware that at this point we need protection _from_ the Bankruptcy Code. We strongly urge that Congress amend the Code in ways that will minimize the time that the store of a bankrupt shopping center tenant may be closed. It is in the interest of all of the other tenants of the shopping center and of the shopping center itself that a closed location be reopened as soon as possible. Whatever benefits exist for debtors under the present law are far outweighed by the detriments to the rest of us in these situations.

IMPORTANCE OF COMPLYING WITH USE CLAUSE-- ESPECIALLY IN THE CASE OF A MAJOR TENANT

The other merchants in the Frederick Shopping Center were fortunate that Food Fair assigned its lease to another grocery store. Had that lease been assigned to any business other than a grocery store, the negative effect on the shopping center would probably have been permanent and irreversible.

I cannot emphasize too strongly the fact that all of the other tenants of the Frederick Shopping Center depend upon the existence of a centrally located grocery store in the shopping center to draw customers and generate sales for them. In the absence of such a store, none of us would get the benefit of the bargain which we have with the shopping center landlord which was based on the assumed continued operation of a grocery store as part of the tenant mix.

We pay shopping center rents which are higher than rents we would pay for the same amount of space elsewhere because we understand that the drawing power of the grocery store, and of all of the other tenants, will provide traffic sufficient to pay these higher rents. The assignment of a lease to a business use other than that specified in the lease agreement, especially in the case of a major tenant, would be a disaster. It would completely eviscerate the agreement we have with the shopping center and it would likely cause substantial harm to the other tenants. In some instances this could even threaten their bankruptcies as well.

CONCLUSION

The merchants of the Frederick Shopping Center strongly support the changes in the Bankruptcy Code which last year's bill, S. 2297, would have made. These changes are necessary and establish a fair balance of the interests of the bankrupt tenant and the other tenants in a shopping center. This is so even in the view of a tenant, who must view these changes from the perspective of one who might some day need the protections of the Code.

I urge Congress to act on these proposals as soon as possible to avoid further unnecessary harm to shopping center tenants across the country.

I thank the Subcommittee for its consideration of my views.

TIMESHARING AGREEMENTS AMENDMENTS

Senator **Dole**. Our final witness is Carl Berry, chairman, National Timesharing Council, American Land Development Association.

As I understand, this amendment was made a part of the compromise legislation. There were some problems discovered, and I understand that is now in the process of at least some discussion at the staff level.

Mr. Berry, I would appreciate it if you could summarize your statement briefly. I am 20 minutes late now to another appointment.

STATEMENT OF CARL G. BERRY, CHAIRMAN, NATIONAL TIMESHARING COUNCIL, ACCOMPANIED BY THOMAS C. FRANKS, DIRECTOR OF GOVERNMENT RELATIONS, AMERICAN LAND DEVELOPMENT ASSOCIATION, AND JEFFREY BLAKE STERN, INGERSOLL & BLOCH, LTD.

Mr. **Berry**. Thank you. I am president of California Resorts Co. We are a timeshare development, management and consulting company located in San Francisco, Calif. I am here today as chairman of the National TimeSharing Council of the American Land Development Association [ALDA]. To my right are Thomas C. Franks, ALDA's director of Government Relations, and Jeff Stern of the Washington, D.C., law firm of Ingersoll & Bloch.

The National TimeSharing Council of the American Land Development Association was created especially to represent real estate developers, property owners, marketers, lenders, and others engaged in every form of timesharing.

This proposed bankruptcy law revision, which was made a part of last year's Senate omnibus bankruptcy bill, and introduced in last year's session as Senate bill 3027, provides the needed consumer protections in the fast-growing timeshare industry. We would like to extend our gratitude to Senator Orrin G. Hatch for introducing S. 3027, and to Chairman Strom Thurmond and Chairman Robert J. Dole for their key support in having these important amendments placed in the omnibus bankruptcy bill last year.

Before addressing our specific problem and proposed solution, let me briefly explain the timeshare concept and industry. Since the early 1970's, an estimated 500,000 American consumers have turned to a new form of real estate purchase known as timesharing to satisfy their recreational and vacation accommodation needs.

There are two broad categories of timeshare interests: Fee-simple ownership of the week or weeks purchased in the timeshare project; or the "right-to-use" accommodations for a week or weeks for a specified number of years without acquiring an actual ownership interest in the project. We are here today to urge you to amend the Federal Bankruptcy Code to protect the rights of timeshare consumers.

The problem: Last year, in the case of *In Re Sombrero Reef Club, Inc.*, a U.S. bankruptcy court held that right-to-use timeshare purchase contracts were executory and could be rejected by the debtor-in-possession developer, thereby allowing the sale of the resort property free and clear of the interest of the consumer purchasers. This adverse decision even affected those consumers who had paid for their interests in full, leaving all the timeshare purchasers with only a general, unsecured claim against the bankrupt estate. It is important to note that this occurred even though required protections under Florida law were in place.

The *Sombrero* decision has sent shock waves throughout the entire timeshare industry. Even now the *Sombrero* case is being cited as precedent in bankruptcy proceedings in the States of Florida, South Carolina, and Utah. Lenders are understandably more hesitant to grant loans secured by right-to-use receivables or to purchase such receivables because the duration of the underlying consumer interest could be cut short at any time by a developer bankruptcy. Unfortunately, this lender hesitancy is causing a shortage of available capital for use by "right-to-use" timeshare developers, thereby forcing the timeshare projects of these developers closer to the brink of bankruptcy and compounding consumer concern.

Senator DOLE. Your time has expired; if you could wrap it up.

Mr. BERRY. Yes.

The solution: The bankruptcy amendments we are advocating for your consideration and adoption are contained in last session's S. 3027, which is attached as part of my statement.

Conclusion: Mr. Chairman, we respectfully urge the adoption of these proposed amendments. The major reasons why these amendments deserve your support are:

This proposal affords needed safeguards for consumers who have no protection in the event of a developer bankruptcy.

Lenders will be given greater security in their collateral, thus allowing them to make more financing available.

Timeshare project owners will benefit from greater consumer and lender confidence afforded by these amendments.

In summary, I believe that after a careful examination of this proposal, you will arrive at the conclusion that this legislation serves the interest of consumers within the confines of the existing policies of the Bankruptcy Code and provides the needed certainty for a growing industry of our Nation.

Mr. Chairman, I would like to thank you for this opportunity to testify on behalf of the National Timesharing Council.

Senator **Dole**. There are some questions raised that are now being discussed at the staff level.

I might also say for the record that we will keep the hearing record open for 2 weeks on all the provisions we have had testimony on in case someone has a different view or someone wants to add to the testimony based on other witnesses' testimony.

Senator Heflin, do you have any questions?

Senator **Heflin** [presiding]. Basically, as I understand your problem, it is, we will say, there is a resort, and I have a right-to-use apartment for certain periods of time, or else I have a share in the ownership.

The bankruptcy trustee under this decision has in effect declared that I am an unsecured creditor.

Now, the solution has been largely that if the trustee rejects the contract, the purchaser may treat such contract as terminated and receive a lien on the timeshare investment, or the purchaser may continue to exercise his right-to-use and occupy the timeshare property.

Just off hand, without going into great detail, it would appear that the right to use the timeshare promise seems to be more equitable. Is there any reason why that is wrong, or would it not be?

Mr. **Berry**. The provisions we are speaking to relate specifically to the right to use our product rather than the type wherein one receives a deed to the property, and the ability to continue to use the property has been jeopardized under the provisions in the Federal bankruptcy law, so we would like to ask that the owners in projects that become bankrupt be treated as lessees or purchasers, because we are a real estate product, even though we are not specifically a leasehold interest. We function like a leasehold interest, but we are not.

Senator **Heflin**. All right, sir. Is there anything else that you gentlemen or your aides or coordinators wish to add?

Mr. **Berry**. No, sir.

Senator **Heflin**. Thank you.

[Submissions of Mr. Berry follow:]

PREPARED STATEMENT OF CARL G. BERRY

Mr. Chairman, my name is Carl Berry, and I am President of California Resorts Company. We are a timeshare development, management and consulting company based in San Francisco, California. I am here today as Chairman of the National TimeSharing Council of the American Land Development Association ("ALDA"). Accompanying me is Thomas C. Franks, ALDA's Director of Government Relations.

The American Land Development Association ("ALDA") represents leading national and international companies which develop timeshare resorts, recreational resorts and residential real estate, including vacation homes, condominiums, planned unit developments, new communities, mobile home parks, and recreational vehicle parks and campgrounds. ALDA's membership includes the real estate development subsidiaries of some of the nation's largest corporations as well as privately-held development companies.

The National TimeSharing Council is one of six councils within the American Land Development Association and was created especially to represent real estate developers, property owners, marketers, lenders, and others engaged in every form of timesharing.

I. Introduction:

I appreciate this opportunity to appear here today to discuss the need for an important change to the existing bankruptcy law. This proposed bankruptcy law revision, which was made a part of last year's Senate Omnibus Bankruptcy Bill, and introduced in last year's session as Senate Bill 3027, provides the needed consumer protections in the fast-growing timeshare industry. We would like to extend our gratitude to Senator Orrin G. Hatch for introducing S. 3027, and to Chairman Strom

Thurmond and Chairman Robert C. Dole for their key support in having these important amendments placed in the Omnibus Bankruptcy Bill last year.

Before addressing our specific problem and proposed solution, let me briefly explain the timeshare concept and industry.

II. Background:

Since the early 1970's, American consumers have increasingly turned to a new form of real estate purchase known as timesharing to satisfy their recreational and vacation accommodation needs. The timeshare industry has grown from as few as eight resorts in 1972, to over 800 resorts nationwide containing more than 25,000 units. It is now estimated that almost 500,000 American consumers have purchased a timeshare interest.

There are two broad categories of timeshare interests: fee-simple ownership of the week or weeks purchased in the timeshare project; or the "right-to-use" accommodations for a week or weeks for a specified number of years without acquiring an actual ownership interest in the project. Both types of timesharing (fee-simple and right-to-use) offer the consumer numerous advantages including reduced-cost recreational accommodations, certainty of accommodations, and opportunities for increased vacation opportunities via exchanges of accommodations with other timeshare owners throughout the world.

However, a recent decision by a Federal Bankruptcy Court in Florida jeopardizes the rights of consumers and threatens the viability of timeshare developers and financial institutions involved in the timesharing industry. Due to the detrimental impact of this decision, we are here today to urge you to amend the Federal Bankruptcy Code to protect the rights of timeshare consumers.

III. The Problem:

Last year in the case of In re Sombrero Reef Club, Inc., 18 B.R. 612 (Bankr. S.D. Fla. 1982), the U. S. Bankruptcy Court held that "right-to-use" timeshare purchase contracts were executory and could be rejected by the debtor-in-possession developer, thereby allowing the sale of the resort property free and clear of the interest of the consumer purchasers. This adverse decision even affected those consumers who had paid for their interests in full, leaving all the timeshare purchasers with only a general, unsecured claim against the bankrupt estate.

Under the Bankruptcy Code, the threshold question before rejection is allowed is whether the contract is executory. Professor Vern Countryman, a noted bankruptcy expert and professor of law at Harvard University, has defined an executory contract as one "under which the obligation of the bankrupt and other party is so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other". This definition was used by the Sombrero Court to reject all of the consumer contracts, even those which had been paid in full, because substantial services would still be required from the developer and annual service fees would be required from consumers. This decision that the consumer purchase contracts were executory permitted the bankrupt debtor-in-possession to reject the consumer contracts and sell the resort property free and clear of consumers' timeshare interests. It is important to note that this occurred even though Florida law prohibited such a sale. The Bankruptcy Court simply preempted the required Florida consumer protections. The Court's preemption of the state law makes it absolutely clear that the only way to resolve this problem is by amending the Federal Bankruptcy law.

The Sombrero decision has sent shock waves throughout the entire timeshare industry. Even now Sombrero case is being cited as precedent in bankruptcy proceedings in the states of Florida, South Carolina and Utah. Kenneth Harney, a nationally syndicated real estate columnist has sounded the alarm in his column for thousands of right-to-use timeshare consumers concerning the lack of protection for their interests in the event of a developer bankruptcy. Sombrero has forced consumers to consult their "crystal balls" in order to predict whether during the lifetime of their contracts, a period of twenty, thirty or more years, the developer will ever file for bankruptcy. Lenders are understandably more hesitant to grant loans secured by right-to-use receivables or to purchase such receivables because the duration of the underlying consumer interest could be cut short at any time by a developer bankruptcy. Unfortunately, this lender hesitancy is causing a shortage of available capital for use by "right-to-use" timeshare developers, thereby forcing the timeshare projects of these developers closer to the brink of bankruptcy and compounding consumer concern.

Let me emphasize that the Sombrero problem not only jeopardizes "right-to-use" timesharing but also jeopardizes all forms and aspects of timesharing through adverse publicity and the creation of a negative image in the minds of consumers. Such adverse publicity directly impacts the timeshare consumer by threatening the existence of his purchase and damaging the continued viability of the timeshare industry which is an integral part of the growing tourism industry. Timesharing alone accounted for an estimated billion and a half dollars in sales volume during 1982.

Mr. Chairman, I believe the foregoing explains the urgency of this matter and why it is imperative to address this consumer problem now.

IV. The Solution:

The bankruptcy amendments we are advocating for your consideration and adoption are contained in last session's S. 3027, which is attached as part of my statement. The proposed amendments enlarge several sections of the Federal Bankruptcy Code to correct the Sombrero problem in a manner we think consistent with the philosophy and provisions of the existing Code.

The proposed amendments provide the same Section 365 protection for timeshare consumers as currently provided in Section 365 (h)(i) and (j) for lessees and purchasers of real property. In other words, the resolution of this problem will require no departure from the philosophy of the existing Code, but instead represents recognition of and accommodation for a growing industry in the Federal Bankruptcy Code.

Sections One and Two of the proposed amendments modify Section 365 of the Bankruptcy Code to include timeshare interests and consumers within the existing protections of Section 365(h)(i) and (j) afforded to lessees and purchasers of real property. Like lessees and purchasers of real property, the proposed addition of subsection (L) would allow timeshare consumers to continue to exercise their rights under their contracts even after rejection by the trustee of debtor-in-possession. Alternatively as in the existing subsection (j) for purchasers of real property, the timeshare consumers would be allowed the option to treat their contracts as terminated and receive a lien against the estate for the value of the unused portion of their purchased interest.

This option is similar to the choice currently provided to purchasers of real property and serves to preserve the effect of any voluntary or state-required contractual obligations such as non-disturbance clauses whereby the seller agrees not to sell the underlying resort property unless the property remains subject to the rights of the timeshare consumers. The Sombrero Court specifically stated that the required Florida non-disturbance clause was of no use to the timeshare consumers because the federal bankruptcy law preempted the state law protection. This proposed amendment would give effect to such state law protections for the benefit of timeshare consumers.

In fairness to the debtor-in-possession, we are urging the inclusion of an additional amendment which will require the timeshare consumer to decide which alternative he wishes to elect within forty-five days of receipt of notice of his contract rejection.

Section Three of the proposed amendments modifies subsection (f) of Section 365 to allow timeshare consumers the option of treating their contracts as terminated if the contracts are assumed and assigned. Because resort management often depends on the individuals involved, timeshare consumers may feel uneasy about the new assignee. Adequate assurance in these cases would prove difficult. Rather than subject consumers to a prolonged fight over the adequacy of the assurance resulting in the inevitable hard feelings and negative publicity (whether in print or through disgruntled consumers), we suggest that terminating the contract is a painless option to grant consumers and clearly reflects the best interests of the consumers. This option grants consumers the right to choose to receive a refund for the unused portion of their contracts.

Section Four of the proposal amendments seeks to prevent the circumvention of the above described protections and alternatives by removing the trustee's ability to void the timeshare purchaser contracts through use of Section 544 of the Bankruptcy Code rather than rejecting the contracts through use of Section 365. Sections 365 and 544 are interrelated. Section 544(a)(3) allows a trustee to avoid a transfer of real property, while Section 365 permits the rejection of unexpired leases or executory contracts. To avoid a lease or executory contract is to terminate the lease or executory contract. Rejection of a lease or contract results in the cancellation of the covenants requiring performance by the debtor-seller in the future, but does not automatically terminate the contract or lease in such a way as to divest consumers of their interests. Once the lease or executory contract is avoided, none of the protections of the proposed amendments to Section 365 would apply. For this reason, it is important to amend Section 544(a)(3) to prevent the circumvention of the protections our proposed amendments would afford to the timeshare consumer.

V. Conclusion:

Mr. Chairman, we respectfully urge the adoption of these proposed amendments. The major reasons why these amendments deserve your support are:

*This proposal affords needed safeguards for consumers who have no protection in the event of a developer bankruptcy. It is inherently unreasonable to require consumers to predict the future with such accuracy in order to anticipate a timeshare developer's bankruptcy. Consumers deserve these protections to preserve some semblance of the benefit of their contractual bargains in a bankruptcy proceeding.

*Lenders will be given greater security in their collateral, thus allowing them to make more financing available. Also, greater lender confidence will relieve severe cash flow problems and lessen the potential for future bankruptcies.

*Timeshare project owners will benefit from greater consumer and lender confidence afforded by these amendments. This in turn will encourage greater economic vitality in the many states where recreational and resort development is a major employer and contributor to the economy.

In summary, I believe that after a careful examination of this proposal, you will arrive at the conclusion that this legislation serves the interest of consumers within the confines of the existing policies of the Bankruptcy Code and provides the needed certainty for a growing industry of our nation.

Mr. Chairman, I would like to thank you for this opportunity to testify on behalf of the National TimeSharing Council.

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II

97TH CONGRESS
2D SESSION

S. 3027

To amend the Bankruptcy Act regarding executory contracts, and for other purposes.

IN THE SENATE OF THE UNITED STATES

OCTOBER 1 (legislative day, SEPTEMBER 8), 1982

Mr. HATCH introduced the following bill; which was read twice and referred to the Committee on the Judiciary

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A BILL

To amend the Bankruptcy Act regarding executory contracts, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 365 of title 11, United States Code, is amended—

(1) by striking from subsection (a) "and (d)" and inserting in lieu thereof ", (d) and (l)".

SEC. 2. Section 365 of title 11, United States Code, is amended by adding after subsection (k) the following:

"(l)(1) If the trustee rejects an executory contract of the debtor for the sale of a timeshare interest in a timeshare plan under which the purchaser has not relinquished the right to occupy and use the timeshare premises, such purchaser may treat such contract as terminated and receive a lien on the interest of the debtor in the timeshare premises for the recovery of any portion of the purchase price that such purchaser has paid less any portion of the purchaser price attributable to years prior to the contract rejection. In the alternative, such purchaser may continue to exercise his rights to use and occupy the timeshare premises to the extent provided in the timeshare plan contract or applicable state law, so long as such purchaser continues to make all required installment and maintenance payments.

"(2) If such purchaser continues to use and occupy the premises, such purchaser may offset against any installment and/or maintenance payments any damages occurring after the date of the trustee's rejection caused by the nonperformance of any obligation of the debtor after such date, but such purchaser does not have any rights against the estate on account of any damages arising after such date from such rejection, other than such offset. The amount eligible for such offset shall be fixed as a sum certain after notice and hearing.

"(3) For the purposes of this section, "timeshare plan" means any arrangement, plan, scheme, or similar device, but not including exchange programs, whether by membership, agreement, tenency-in-common, sale, lease, deed, rental agreement, license, right-to-use agreement, by any other means, whereby a purchaser, in exchange for consideration, receives right-to-use accommodations or facilities, or both, for a specific period of time less than a full year during any given year, but not necessarily for consecutive years, and which extends for a period of more than three years. A timeshare interest is that interest purchased in a timeshare plan which grants purchaser the right to use and occupy facilities or accommodations pursuant to a timeshare plan. Timeshare premises are those facilities and/or accommodations subject to a time share plan.".

SEC. 3. Section 365(f)(2) of title 11, United States Code, is amended by—

(1) striking out "and" at the end of subparagraph (A);

(2) striking out the period at the end of subparagraph (B) and inserting in lieu thereof "; and"; and

(3) adding at the end thereof the following new subparagraph:

"(C) in the case of timeshare interest purchaser, the timeshare interest purchasers are given the option to treat their executory contracts as terminated pursuant to section 365(l)(1) of this title.".

SEC. 4. Section 544(a)(3) of title 11, United States Code, is amended by inserting after "exists" the following: ";

however, nothing in this subsection shall be construed to grant the trustee the power to assert the rights and powers of a bona fide purchaser against the contractual or state-mandated rights of any timeshare interest purchaser in a timeshare plan as defined in section 365(l)(3)".

Senator **Heflin**. The record will be held open 2 weeks for anybody to file any statements, and for answers to come and for raw data to be received from Purdue University. If that does not get in in 2 weeks, we will still accept it.

With that, we will conclude the hearing. Thank you very much.

[Whereupon, at 12:55 p.m., the hearing was concluded.]

APPENDIX

SUBMISSIONS RELATING TO THE NORTHERN PIPELINE V. MARATHON DECISION

STATEMENT OF THE COMMERCIAL LAW LEAGUE OF AMERICA

The Commercial Law League urges that legislation to reconstitute the bankruptcy courts in the wake of the Supreme Court's decision in Northern Pipeline be adopted as separate specific legislation, rather than as part of a package including amendments to various sections of the Bankruptcy Reform Act.

We recognize the reasons for considering amendments on court structure as part of a package of amendments to various sections of the Bankruptcy Code, and we concur in the need for certain amendments on provisions other than court structure; but we believe that it is imperative that Congress act immediately to reconstitute the bankruptcy courts, without the delays possibly occasioned by consideration of other issues, to avoid the already chaotic bankruptcy system becoming ineffective and totally unworkable.

Since early in the nineteenth century it has been national policy to provide a legal framework within which debtors and creditors can deal with conditions of financial distress. Never has the bankruptcy system been so precarious as in the present situation.

In every bankruptcy case there now lurks the potential for challenge to any and every aspect of the case. Certainty, predictability and even continuity are lacking. In a sense, it is almost as though the bankruptcy process now exists solely for the benefit of the litigious.

A simple example will illustrate. Many bankruptcy cases involve liquidation proceedings initiated by individuals who have no non-exempt assets with which to satisfy any creditor. Prior to Northern Pipeline, in such a case the bankruptcy petition was filed, the circumstances of the debtor were established, the record of the debtor's condition and the creditors' claims was made and the matter proceeded to its conclusion with the debtor being discharged of all dischargeable debts and creditors receiving nothing. Today, however, a sufficiently disgruntled creditor can, for relatively little additional cost, frustrate the entire process.

Upon the filing of the petition by the debtor, an order for relief is entered. This order for relief, ordinarily a simple ministerial act, follows from the judicial authority to act in bankruptcy. If there is a basis upon which to question that judicial authority, a basis which Northern Pipeline now provides, then the entire process is called into question and totally frustrated. As long as the bankruptcy authority of the federal courts is in question because of Northern Pipeline, such a situation may arise.

There is virtually no aspect of a bankruptcy case not subject to some type of Northern Pipeline challenge. No other provision in the package of bankruptcy amendments is so critical as reconstituting the bankruptcy courts to assure continued operation of the bankruptcy system.

There is a clear and unambigous prescription to cure the problem. If bankruptcy courts had been constituted in the Bankruptcy Reform Act of 1978 pursuant to Article III of the Constitution, there would have been no question as to their authority to act and there would have been no "Northern Pipeline problem". Bankruptcy courts must be reconstituted pursuant to Article III to place the bankruptcy system back on the track Congress established for it in 1978; and we urge that legislative action be taken promptly to so reconstitute those courts.

Delegation of Authority and the Model Rule: The Continuing Saga of *Northern Pipeline*[*]

Charles F. Vihon
Special Counsel to the League
Cape Elizabeth, Maine

THE STRUCTURE[1] AND JURISDICTION[2] of the federal courts that were intended by Congress in the Bankruptcy Reform Act of 1978[3] to hear and adjudicate bankruptcy and bankruptcy-related matters[4] was the result of decisions and compromises made in the very final stages of the legislative process through which that statute passed before its enactment.[5] One of these last-minute compromises resulted in the provision in the Reform Act for bankruptcy judges to exercise certain jurisdiction without being appointed pursuant to Article III of the Constitution.[6] It was this aspect of the Reform Act that caused the Supreme Court to invalidate "the broad grant of jurisdiction to the bankruptcy courts contained in §241(a)" thereof.[7] Because "Congress . . . vested jurisdiction . . . in a single non-Art. III court and . . . [did] so pursuant to a single statutory grant of jurisdiction",[8] the Court felt that it was "for Congress to determine the proper means of restructuring the Bankruptcy Act of 1978 to conform to the requirements of Art. III in the way that will best effectuate the legislative purpose."[9]

To "afford Congress the opportunity to reconstitute the bankruptcy courts or to adopt other valid means of adjudication, without impairing the interim administration of the bankruptcy laws",[10] the Court stayed its judgment.[11] However, Congress was unable to legislate in that regard[12] and the Court's mandate[13] now has become effective. In the wake of Congress's inaction and the effectiveness of the *Northern Pipeline* mandate as of December 25, 1982, the bankruptcy system now operates under the aegis of local rules adopted by the district courts "to supplement existing law and rules in respect to the authority of the bankruptcy judges . . . to act in bankruptcy cases and proceedings until Congress enacts appropriate remedial legislation".[14] Those local rules have been adopted with reference to a "model rule" developed by the Administrative Office of the United States Courts upon the direction of the Judicial Conference of the United States.[15]

It is the purpose of this paper to examine the model rule and the authority asserted for its promulgation. Since the purpose of the model rule is to deal with a perceived void in providing for the authority of bankruptcy judges, a brief summary will be given of what the authority of bankruptcy judges was intended to be under the Reform Act.

Introduction

For the purposes of the Reform Act, Congress created a new bankruptcy court that was to be "an adjunct to the district court".[16] The district court was invested with jurisdiction over all bankruptcy and bankruptcy-related matters[17] but "The bankruptcy court . . . [was to] exercise all of the jurisdiction conferred on the district courts."[18]

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[*] A complete transcript of Director William E. Foley's December 3, 1982, memorandum and the model rule begins on page 76 of this issue of the *Journal*.

[1] Cf. 28 U.S.C. Part I, Organization of Courts.

[2] Cf. 28 U.S.C. Part IV, Jurisdiction and Venue.

[3] Public Law 95-598 (hereinafter referred to as the "Reform Act"), §§201 (enacting 28 U.S.C. §§151-160) and 241 (enacting 28 U.S.C. §§1471-1482).

[4] *See*, H Rep. 95-595, 95th Cong. 1st Sess. (1977), pp. 48-49.

[5] *See generally*, Klee, *Legislative History of the New Bankruptcy Law*, 28 De Paul L. Rev. 941 (1979).

[6] *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, ___ U.S. ___, 102 S. Ct. 2858, 2866 (1982).

[7] *Supra*, *Northern Pipeline*, at 2880.

[8] *Id.*, at note 40.

[9] *Id.*

[10] *Supra*, note 7.

[11] *Id.* The court further stayed its mandate until December 24, 2982.

[12] *New York Times*, December 28, 1982,at D1.

[13] *Supra*, note 7.

[14] *See* Appendix A, §(a), p. 1.

[15] *See* Appendix B, p. 1.

[16] Pub.L. 95-598, §201(a) (enacting 28 U.S.C. §151(a)).

[17] *Supra*, note 4, and Pub.L. 95-598, §241(a) (enacting 28 U.S.C. §§1471(a) and (b).

[18] Pub.L. 95-598, §241(a) (enacting 28 U.S.C. §1471(c)).

And, generally, the bankruptcy court was to "have the powers of a court of equity, law, and admiralty"[19] and be enabled to "issue any order, process, or judgment . . . necessary or appropriate to carry out the provisions of this title."[20] However, "full implementation of the changes proposed by the"[21] Reform Act were to "take place over a period of approximately five years"[22] during a transition period.

> The purpose of the transition period is to allow time for a study of the number of bankruptcy judges needed under the new court system proposed by the bill. The bill creates a new court system, and substantially changes the administration of bankruptcy cases . . . the bill also expands the jurisdiction of the bankruptcy court, bringing into the bankruptcy court laws [sic] suits that might now be brought elsewhere . . . the transition period is designed to simulate operation under the new law and new court structure, in order to permit an accurate measurement of the needs of the bankruptcy system. (H.Rep. 95-595, 95th Cong., 1st Sess. (1977) 287.)

Operation of the bankruptcy system during the transition period, designed to simulate the new court structure and jurisdiction,[23] was accomplished somewhat by indirection because the provisions in the Reform Act for the new court and its jurisdiction were not to become effective until April 1, 1984.[24] The simulation was accomplished by providing especially for courts,[25] jurisdiction and procedure[26] during the transition period, basing this upon what was supposed to happen in 1984.[27] (1) Instead of there being an United States Bankruptcy Court as an independent adjunct of the district court,[28] "The courts of bankruptcy . . . existing on September 30, 1979 . . . [were to] continue through March 31, 1984 . . . [as] a separate department of the district court that is such court of bankruptcy . . ."[29] (2) Instead of the amendments to title 28 of the United States Code regarding bankruptcy judges governing such office,[30] "matters relating to the office of United States bankruptcy judges and to United States bankruptcy judges shall continue to be governed during the transition period by the rules set forth in sections 34, 35, 36, 40a, 40b, 40d, 41 and 43 of the Bankruptcy Act as such Act existed on September 30, 1979."[31] (3) Instead of bankruptcy judges exercising all of the jurisdiction invested in district courts,[32] "[a]ll cases commenced under title 11 of the United States Code during the transition period shall be referred to the United States bankruptcy judges . . . [and] United States bankruptcy judges may exercise in such cases the jurisdiction and powers conferred by subsection (b) of this section on the courts of bankruptcy continued by section 404(a) of this Act, and all proceedings in such cases shall be before the United States bankruptcy judges . . . [except certain matters not relevant here[33] and, except for appeals from a judgment, order or decree of a United States bankruptcy judge[34]] any proceeding in a court of bankruptcy in a case under title 11 of the United States Code that is not before the United States bankruptcy judge shall be before the judge of the court of bankruptcy for the district in which such case is pending."[35] (4) Instead of the jurisdiction and powers of 28 U.S.C. §§1471-1481,[36] 1869[37] and 2256[38] being made applicable directly to bankruptcy judges,[39] "During the transition period, the amendments made by sections 241, 243, 250, and 252 of this Act shall apply to the courts of bankruptcy continued by section 404(a) of this Act the same as such amendments apply to the United States bankruptcy courts established under section 201 of this Act."[40] And, (5) instead of appeals from judgments, orders and decrees of bankruptcy judges being governed directly by the amendments to 28 U.S.C. §§1293,[41] 1334[42] and 1482.[43]

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[19] Pub.L. 95-598, §241(a) (enacting 28 U.S.C. §1481).

[20] 11 U.S.C. §105(a).

[21] *Supra*, note 4, at p. 287.

[22] *Id.*

[23] *Id.*

[24] Pub.L. 95-598, §402.

[25] Pub.L. 95-598, §404.

[26] Pub.L. 95-598, §405.

[27] Pub.L. 95-598, §§201 and 241.

[28] *Supra*, note 16.

[29] *Supra*, note 25, at subsection (a).

[30] Pub.L. 95-598, §201.

[31] *Supra*, note 25, at subsection (d).

[32] *Supra*, note 18.

[33] *Infra*, text at note 143.

[34] *Id.*

[35] *Supra*, note 26, at subsection (a)(2).

[36] 1471. Jurisdiction.
1472. Venue of cases under title 11.
1473. Venue of proceedings arising under or related to cases under title 11.
1474. Venue of cases ancillary to foreign proceedings.
1475. Change of venue.
1476. Creation or alteration of district or division.
1477. Cure or waiver of defects.
1478. Removal to the bankruptcy courts.
1479. Provisional remedies; security.
1480. Jury trials.
1481. Powers of bankruptcy court.
1482. Appeals.

[37] The amendment to 28 U.S.C. §1869(f) effected by Pub.L. 95-598, §243, added to the definition of "district court of the United States" courts constituted under "Chapter 6 of title 28", to wit, the United States Bankruptcy Court created by 28 U.S.C. §151, for the purpose of application of the provisions regarding trial by jury.

[38] A new provision for "*habeas corpus* from bankruptcy courts."

[39] The distinction between direct and indirect application of these provisions was not made by the Supreme Court in its decision in *Northern Pipeline*. It may be theoretically significant because it was not, for example, Pub.L. 95-598, §241(a) that was applicable in *Northern Pipeline* but Pub.L. 95-598, §405(b) cross-referencing the substance of that which will, or at least would, after April 1, 1984, constitute Pub.L. 95-598, §241(a). Had the Supreme Court rendered its decision identifying with technical accuracy the applicable sections of the Public Law, it is arguable that after April 1, 1984, §241(a) would be valid.

[40] *Supra*, note 26, at subsection (b).

> "(1) During the transition period, an appeal from a judgment, order, or decree of a United States bankruptcy judge shall be—
>
> (A) if the circuit council of the circuit in which the bankruptcy judge sits so orders for the district in which the bankruptcy judge sits, then to a panel of three bankruptcy judges appointed in the manner prescribed by section 160 of title 28 of the United States Code, as added by section 201 of this Act;
>
> (B) if the parties to the appeal agree to a direct appeal to the court of appeals for such circuit, then to such court of appeals; or
>
> (C) to the district court for the district in which the bankruptcy judge sits.
>
> (2) During the transition period, the jurisdiction of the district courts, the courts of appeals, and panels of bankruptcy judges to hear appeals shall be the same as the jurisdiction of such courts and panels granted under the amendments made by sections 236, 237, 238, and 241 of this Act to hear appeals from the judgments, orders, and decrees of the bankruptcy courts established under section 201 of this Act."[44]

The model rule does recognize the differences between the bankruptcy system as it is proposed to be after April 1, 1984, with its separate and independent bankruptcy court and as it was intended to operate during the transition period within the purview of the district court as the court of bankruptcy. But in effecting this recognition, the model rule alters the bankruptcy system in a way that goes far beyond, and does not comport with, the premise upon which the model rule suggests it is based, to wit, that *Northern Pipeline* really had only a very limited invalidating effect upon the Bankruptcy Reform Act.[45] Instead, the model rule seems to accord to *Northern Pipeline* a vastly more sweeping and pervasive effect. As will be seen, it is the adherence simultaneously to these polar opposite positions that in part contributes to the problems created by this rule.

Jurisdiction in Bankruptcy

One of the elements of the memorandum accompanying the model rule,[46] and presumably, a touchstone for the asserted validity and efficacy of the rule, is the comment that the Judicial Conference had "advised Congress of its belief that the Supreme Court decision [in *Northern Pipeline*] did not completely invalidate subsections (a) and (b) of section 1471 of Title 28, United States Code, as enacted in section 241(a) of the 1978 Act."[47] The only reason that such a statement would be made would be to lay the foundation for basing the district court's jurisdiction in bankruptcy on 28 U.S.C. §§1471(a) and (b), and, therefore its authority to delegate matters within the scope of that jurisdiction to bankruptcy judges.[48] That this can be so in the face of the Supreme Court's careful crafting of its judgment[49] is highly questionable. Moreover, there is nothing, absolutely nothing, in the Court's judgment—or in any of the opinions—to suggest that those provisions were examined by the Court to determine their validity in whole or in part.[50]

Notwithstanding there was no majority opinion in *Northern Pipeline*, and notwithstanding the plurality and concurring Justices differed as to what was the exact issue to be decided,[51] nevertheless those six Justices[52]—a majority of the Court—did agree on one proposition: that the grant of authority to bankruptcy judges to decide certain matters under Pub.L. 95-598 §241(a) was not severable from the overall grant of authority to the bankruptcy judges under the Reform Act and, therefore, the entirety of §241(a) had to be stricken down.[53] Nothing in either the plurality or the concurring opinion suggests that, even though most of the provisions of §241(a)[54] never were discussed or even questioned, the Court would try to carve out from that section what it felt might have been the "really" constitutionally offending provision. Contrariwise, as the plurality noted:

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[41] §1293. Bankruptcy appeals.

(a) The courts of appeals shall have jurisdiction of appeals from all final decisions of panels designated under section 160(a) of this title.

(b) Notwithstanding section 1482 of this title, a court of appeals shall have jurisdiction of an appeal from a final judgment, order, or decree of an appellate panel created under section 160 or a district court of the United States or from a final judgment, order, or decree of a bankruptcy court of the United States if the parties to such appeal agree to a direct appeal to the court of appeals.

[42] §1334. Bankruptcy appeals.

(a) The district courts for districts for which panels have not been ordered appointed under section 160 of this title shall have jurisdiction of appeals from all final judgments, orders, and decrees of bankruptcy courts.

(b) The district courts for such districts shall have jurisdiction of appeals from interlocutory orders and decrees of bankruptcy courts, but only by leave of the district court to which the appeal is taken.

(c) A district court may not refer an appeal under that section to a magistrate or a special master.

[43] §1482. Appeals.

(a) Panels designated under section 160(a) of this title shall have jurisdiction of appeals from all final judgments, orders, and decrees of bankruptcy courts.

(b) Panels designated under section 160(a) of this title shall have jurisdiction of appeals from interlocutory judgments, orders, and decrees of bankruptcy courts, but only by leave of the panel to which the appeal is taken.

[44] *Supra*, note 26, at subsection (c).

[45] *See*, Appendix B, *supra*, note 15, at p.2.

[46] *Supra*, note 15.

[47] *Supra*, note 45.

[48] *See generally*, *Ex Parte Peterson*, 253 U.S. 300 (1920); *accord*, Fed.R.Civ.P. 54.

[49] *Supra*, notes 8 and 9.

[50] Cf. 102 S.Ct. 2862, 2878-9.

[51] [illegible] the question presented for decision: whether the Bankruptcy Act of 1978 violates the command of Art. III that the judicial power of the United States must be vested in courts whose judges enjoy the protections and safeguards specified in that article." Opinion of Brennan, J., 102 S.Ct. 2867. Compare, "Were I to agree with the plurality that the question presented is [illegible] but [illegible]" Opinion of Rehnquist, J., 102 S.Ct. 2880-1.

[52] Brennan, Marshall, Blackmun and Stevens, and Rehnquist and O'Connor.

[53] *Supra*, note 7, and 102 S.Ct. 2882.

[54] *Supra*, note 36.

> We think that it is for Congress to determine the proper manner of restructuring the Bankruptcy Act of 1978 to conform to the requirements of Art. III in the way that will best effectuate legislative purpose.[55]

Therefore, that there is any support in *Northern Pipeline* for the proposition that 28 U.S.C. §§1471(a) and (b)—or any part(s) thereof—can be the basis for district court jurisdiction in bankruptcy would have to be pure sophistry.

Presumably, Congress intended the Reform Act to be an integrated, complete statement regarding the nature and characteristics of the bankruptcy system, to the limits of its own jurisdiction to act pursuant to Art. I, §8, cl. 4 of the Constitution. And this even in the face of the last-minute compromises that had to be accepted if there was to be enactment of any bankruptcy reform legislation.

The provisions regarding court structure and jurisdiction represented a compromise between (1) the position of the House that there should be an Article III bankruptcy court separate and independent from the district court with jurisdiction and powers to hear and finally adjudicate all bankruptcy and bankruptcy-related matters,[56] and (2) the position of the Senate that there should not be such an independent bankruptcy court with such jurisdiction and powers but an Article I adjunct to the district court from which such jurisdiction and powers derived, similar to the pre-1978 referee system.[57] That compromise (the amendments in Pub.L. 95-598, §§201[58] and 241(a)[59]) was more in line with the court structure contained in the Senate bill;[60] with respect to bankruptcy jurisdiction, it first was invested in the district court and then "passed through" to bankruptcy judges adjunct thereto.[61] When *Northern Pipeline* invalidated Pub.L. 95-598, §241(a), it did away with the investiture by the Reform Act of bankruptcy jurisdiction in the district courts as well, of course, as its exercise by the bankruptcy judges.[62] However, since that section was not to become effective until April 1, 1984,[63] and bankruptcy jurisdiction during the transition period is dealt with in Pub.L. 95-598, §405(b),[64] the effect of *Northern Pipeline* was to sever the reference point for the determination of bankruptcy jurisdiction during the transition period. That being the case, it is proper to ask "upon what basis does *any* federal court possess bankruptcy jurisdiction?"

Prior to the enactment of the Reform Act, district courts were the courts of bankruptcy because of their having been invested with that jurisdiction pursuant to 28 U.S.C. §1334.[65] Had the House version of the Reform Act been adopted, that section would have been repealed[66]—presumably confirming that it was the House's intention that the Reform Act would stand as the complete statement of Congress's provision for bankruptcy jurisdiction in the federal courts. However, with the compromise, that section was not repealed but was retained as the vehicle to provide for appeals from bankruptcy courts to district courts.[67] During the transition period, therefore, there was allowed to exist "on the books" two different sections of title 28 providing for bankruptcy jurisdiction, *viz.*, 28 U.S.C. §1334 and 28 U.S.C. §1471, with the latter being the operative provision to be referred to through Pub.L. 95-598, §405(b).[68] Obviously, Congress did not contemplate that 28 U.S.C. §1334 would be or would have to be referred to as the source for bankruptcy jurisdiction.

In the unlikely event that during the transition period a case would raise the jurisdictional issue in terms of which section determined bankruptcy jurisdiction, the application of accepted rules of statutory interpretation would result in referring to 28 U.S.C. §1471.[69] With respect to the effect of *Northern Pipeline*, it now cannot be argued that the reference in Pub.L. 95-598, §405(b) to §241 (and, therefore, to 28 U.S.C. §1471 for purposes of determining bankruptcy jurisdiction) was intended to be a repealer of 28 U.S.C. §1334.[70] This would fail to account for the treatment given to that section in Pub.L. 95-598, §238 with regard to when that provision becomes effective[71] and the purposeful use of it to realize part of the Congressional compromise providing for appeals from the United States Bankruptcy Court to the district court.[72]

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[55] *Supra*, note 9.

[56] H.R. 8200, 95th Cong. 1st Sess., §§201, 213 and 243.

[57] S. Rep. 95-989, 95th Cong. 2nd Sess. (1978), 16.

[58] Pub. L. 95-598, §201(a) enacted the following provisions as additions to title 28:

§151 Creation and composition of bankruptcy courts.
§152 Appointment of bankruptcy judges.
§153 Tenure and residence of bankruptcy judges.
§154 Salaries of bankruptcy judges.
§155 Chief judge; precedence of bankruptcy judges.
§156 Division of business among bankruptcy judges.
§157 Times of holding court.
§158 Accommodations at places for holding court.
§159 Vacant judgeship as affecting proceedings.
§160 Appellate panels.

[59] *Supra*, note 36.

[60] See, S.2266, 95th Cong. 2nd Sess. §216.

[61] *Supra*, notes 16 and 18.

[62] *Supra*, note 7.

[63] Pub.L. 95-598, §402(b).

[64] *Supra*, note 35.

[65] §1334. Bankruptcy Matters and Proceedings

> The district courts shall have original jurisdiction, exclusive of the courts of the States, of all matters and proceedings in bankruptcy.

[66] *Supra*, note 4, at p. 444.

[67] Pub.L. 95-598, §238.

[68] *Supra*, note 35.

[69] ". . . if there is an irreconcilable conflict between the new provision and the prior statutes relating to the same subject matter, the new provision will control as it is the later expression of the legislature." 2A Sutherland, *Statutory Construction*, ¶51.02, p. 290.

[70] First, Congress was quite meticulous in coordinating and conforming other federal statutes to the changes made by Pub.L. 95-598. (See titles II and III thereof.) Second, technically there is no inconsistency between those provisions since Pub.L. 95-598, §405(b) itself does not contain language that would place it in conflict with 28 U.S.C. §1334. And, third, the provisions at 28 U.S.C. §§1471 and 1334 are, in their narrowest senses, in *pari materia* since the former can be considered an explication of the latter, that is to say, that the latter is a general provision for a type of jurisdiction whereas the former identifies the types of cases illustrative of the compass of the latter.

Because the new United States Bankruptcy Court, created pursuant to Pub.L. 95-598, §201, is not to come into existence until April 1, 1984,[73] and because of Congress's intention to provide a transition period between the date of enactment of the Reform Act and the time when "full implementation of the changes made by the bill"[74] is to occur, "The courts of bankruptcy as defined under section 1(10) of the Bankruptcy Act . . . and existing on September 30, 1979, shall continue through March 31, 1984, to be the courts of bankruptcy for purposes of this Act and the amendments made by this Act."[75] However, the district court's jurisdiction in bankruptcy pursuant to 28 U.S.C. §1334 is limited to "original jurisdiction, exclusive of the courts of the States, of all matters and proceedings in bankruptcy."[76] If this is equivalent to the scope of jurisdiction comprehended by 28 U.S.C. §1471,[77] then there may be no question as to the district court's jurisdiction during the transition period and its adequacy to deal with all bankruptcy and bankruptcy-related matters—including the authority to promulgate the model rule.[78] But this is not likely.

It is only "matters and proceedings *in* bankruptcy" jurisdiction over which is invested in the district court pursuant to 28 U.S.C. §1334.[79] Since 28 U.S.C. §1471 comprehends four types of matters[80] and only three of them are "in bankruptcy" by virtue of their being subsumed within title 11,[81] the fourth, "civil proceedings related to cases under title 11", would appear to deal with matters not "in bankruptcy". If this is accurate, where would the district court derive jurisdiction over such matters? And, further, from what source would the district court derive authority to promulgate the model rule with respect to delegating its authority over such bankruptcy-related matters?[82]

It may be that 28 U.S.C. §§1331 and 1332[83] and the judicially developed doctrines of ancillary[84] and pendent[85] jurisdiction, to the extent those predicates allow, can be the basis for district courts' acting with respect to matters within the compass of "civil proceedings related to cases under title 11",[86] but, if so, it would not be as bankruptcy matters. Consequently, insofar as such matters are concerned, it would appear that the Federal Rules of Civil Procedure would be applicable to such matters when heard by the district court and not the Bankruptcy Rules of Procedure.[87] Since the model rule is intended to be a local *bankruptcy* rule,[88] it would appear to be inapplicable to determine practice and procedure, at the minimum, respecting these "non-bankruptcy" matters.[89] This would be confirmed by the limitations contained in the language of Bankruptcy Rule 1, that "The rules . . . govern the procedure in courts of bankruptcy in bankruptcy cases",[90] and Fed. R.Civ.P. 1 that "these rules govern the procedure in the United States district courts in all suits . . . with the exception stated in Rule 81."[91]

Whatever the source of the district court's jurisdiction over bankruptcy and bankruptcy-related matters, and whatever the scope of that jurisdiction, the basis for the authority for district courts to issue rules of procedure is 28 U.S.C. §2071.[92] However, in the memorandum accompanying the model rule, the Director of the Administrative Office of the United States Courts stated in part:

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[71] April 1, 1984, see Pub.L. 95-598, §402.

[72] H.R. 8200 originally would have had all appeals from decisions of the bankruptcy court taken to the courts of appeals.

[73] *Supra*, note 24.

[74] *Supra*, note 21.

[75] *Supra*, note 25, at subsection (a).

[76] *Supra*, note 65.

[77] §1471. Jurisdiction

(a) Except as provided in subsection (b) of this section, the district courts shall have original and exclusive jurisdiction of all cases under title 11.

(b) Notwithstanding any act of Congress that confers exclusive jurisdiction on a court or courts other than the district courts, the district courts shall have original but not exclusive jurisdiction of all civil proceedings arising under title 11 or arising in or related to cases under title 11.

[78] "The federal courts have authority to establish all necessary rules for the orderly conduct of business, provided the rules are not repugnant to the laws of the United States." *Hecker v. Fowler*, 2 Wall. 123 (1865).

[79] *Supra*, note 65.

[80] *Supra*, note 77 (i.e., (1) cases under title 11, (2) civil proceedings arising under title 11, (3) civil proceedings arising in cases under title 11, and (4) civil proceedings related to cases under title 11).

[81] *Id.*, items (1)-(3).

[82] *See, e.g.*, *Hecker v. Fowler*, *supra* note 78.

[83] 28 U.S.C. §1331 provides for jurisdiction in the district courts of civil actions arising under federal law, and 28 U.S.C. §1332 provides for diversity jurisdiction.

[84] *See, for example*, *Edelman v. Jordan*, 415 U.S. 651 (1974), *United Mine Workers v. Gibbs*, 383 U.S. 715 (1966), *Moore v. New York Cotton Exchange*, 270 U.S. 593 (1926) and *Dewey v. West Fairmont Gas Co.* 123 U.S. 329 (1887).

[85] *Id.*

[86] *Supra*, note 80.

[87] "These rules do not prescribe except incidentally the procedure for actions or plenary proceedings brought in state courts or federal district courts to determine controversies that arise in connection with a bankruptcy case." Advisory Committee's Note, Rule 1 (Rules of Bankruptcy Procedure).

[88] Appendix B, supra note 15, at p. 2.

[89] ". . . rules governing practice and procedure under the Act . . ." Rule 927. "'Act' means the Bankruptcy Act." Rule 901(2).

[90] Bankruptcy Rule 1. (Hereinafter reference to the Bankruptcy Rules is as "Rule".)

[91] "These rules . . . do not apply to proceedings in bankruptcy . . ." Fed. R. Civ. P. 81(a)(1). (Hereinafter reference to the Federal Rules of Civil Procedure is as "FRCP".)

[92] §2071. Rule-making power generally

The Supreme Court and all courts established by Act of Congress may from time to time prescribe rules for the conduct of their business. Such rules shall be consistent with acts of Congress and rules of practice and procedure prescribed by the Supreme Court.

> The . . . model rule is intended to be an interim measure, by which district courts may delegate many of their bankruptcy powers to bankruptcy judges. The authority for that delegation is found in section 105 of the 1978 Act, which gives courts of bankruptcy the power to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.[93]

It is likely that the use of 11 U.S.C. §105[94] as the basis upon which to promulgate a rule such as the model rule was not only not intended by Congress but that such a purpose falls far outside any reasonable interpretation made of the language and scope of coverage of that section.

Section 105 of title 11, as the legislative history indicates, "is similar in effect to the All Writs Statute 28 U.S.C. §1651".[95] The applicability of that statute was referred to by the Supreme Court in *Northern Pipeline* as allowing "bankruptcy judges the power . . . to issue all writs necessary in aid of the bankruptcy court's expanded jurisdiction".[96] These frames of reference strongly suggest that 11 U.S.C. §105 is limited by the following considerations: (1) the authority provided by the section is a corollary to, dependent upon and inconsistent without the expanded jurisdiction provided by 28 U.S.C. §1471, (2) only the bankruptcy judge may exercise powers pursuant to the authority of this section, and (3) action taken upon the authority of the section must be with reference to and in connection with a specific case or proceeding of the nature described in (or at least comprehended by) 28 U.S.C. §§1471 (a) and (b).

That 11 U.S.C. §105 is directed toward the new bankruptcy court as contemplated by the amendments in Pub.L. 95-598, §201, and as a function of the expanded jurisdiction such court was to have over bankruptcy and bankruptcy-related matters, seems to follow inexorably from the following:

> The proposed bankruptcy courts will be able to enforce their own orders, and to issue writs of execution in aid of enforcement.[97]

And, that this grant of authority was necessary because bankruptcy courts otherwise did not possess such powers can be seen, first, from the footnote citation to the above-quoted language[98] and, second, from the explanation given to a comparable grant of the power to issue writs of *habeas corpus*:

> Bankruptcy courts are invested, through the power of the district courts, with the power to issue the writ today . . . . Under the proposed law, the bankruptcy courts would be independent of the district courts, and the power would have to stand on its own.[99]

Under the Reform Act, the entire organization and allocation of jurisdiction and authority as between the bankruptcy judge and the district court places the powers of 11 U.S.C. §105 completely within the purview of the bankruptcy judge alone as the intended adjudicator in the first instance.[100] After April 1, 1984, the only role for the district court under the Reform Act is as an appellate tribunal with a relationship between itself and the bankruptcy judge essentially the same as that which exists between itself and its appellate tribunal, the court of appeals. Even during the transition period, that same relationship is intended to exist even though structured indirectly.[101] Moreover, the district court doesn't need an 11 U.S.C. §105-type of authorization without the Reform Act: the All Writs Statute already applies to district courts[102] pursuant to which they may "issue all writs necessary or appropriate in aid of their . . . jurisdiction . . ."[103] They also already possess rule-making authority pursuant to 28 U.S.C. §2071[104] and Fed.R.Civ.P. 83.[105]

The language of 11 U.S.C. §105 is the clearest indication that it was not intended to be the basis for the issuance of general rules concerning judicial officers' exercise of power but as the basis for action regarding a matter *sub judice*: it refers to the issuance of "any order, process, or judgment". This is confirmed by the treatment given the cognate 28 U.S.C. § 1651, i.e., "the section augments the power of a court in cases of existing jurisdiction . . . ."[106] And, as indicated, the authority for issuing general rules derives from an entirely different source.[107]

An additional reference given as the authority for promulgation of the model rule is "Bankruptcy Rule 927" which gives bankruptcy courts the power to adopt "rules governing practice and procedure under the Act".[108]

Rule 927 "is an adaptation of Rule 83 of the Federal Rules of Civil Procedure".[109] Both of these rules deal with an authority to regulate practice and procedure where rules otherwise are not inconsistent. The model rule itself speaks of its purpose as being "to supplement existing law and rules in respect to the authority of the bankruptcy judges . . . to act in bankruptcy cases and proceedings".[110] Both the Reform Act and the model rule generally validate the Bankruptcy Rules "to the extent not inconsistent with the amendments made by this Act"[111] and "to the extent . . . not inconsistent with the holding of *Northern Pipeline*."[112]

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[93] Appendix B, *supra*, note 15, at p. 2.

[94] §105. Power of court.
(a) The bankruptcy court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.

[95] H. Rep., *supra*, note 4, at p. 316.

[96] *Northern Pipeline*, *supra*, note 6, at p. 2863.

[97] H. Rep., *supra*, note 4, p. 12 (footnote omitted).

[98] *Gordon v. U.S.*, 117 U.S. 697 ([illegible]) and *Ex Parte Christy*, 44 U.S. 292 (1845).

[99] H. Rep., *supra*, note 4, at p. 12 note 67.

[100] S. Rep., *supra*, note 57, at p. 18.

[101] *Supra*, note 35 and accompanying text.

[102] See, 28 U.S.C. §451, and H. Rep., *supra*, note 4, at p. 446 (regarding section 214).

[103] 28 U.S.C. §1651.

[104] *Supra*, note 92.

[105] Rule 83. Rules by district court. Each district court by action of a majority of the judges thereof may from time to time make and amend rules governing its practice not inconsistent with these rules . . . in all cases not provided for by rule, the district courts may regulate their practice in any manner not inconsistent with these rules.

[106] *Edgerly v. Kennelly*, 215 F.2d 420, 422 (CA-7, 1954) *cert. den.* 348 U.S. 938.

[107] *Supra*, note 105.

[108] Appendix B, *supra* note 15, at p. 2.

[109] Advisory Committee's Note, Rule 972.

In the Advisory Committee's Introductory Note to the Preliminary Draft of the Bankruptcy Rules, it is stated that "defining the jurisdiction of the court and establishing its structure and personnel are outside the proper concern of the rulemaking authority."[113] Whether that comment should be read as expressing a judgment about rulemaking as a general matter, or merely the particular effort undertaken there pursuant to 28 U.S.C. §2075,[114] it is of note because the model rule is not a product of the 28 U.S.C. §2075 process, that the substance of the model rule has been promulgated as a local bankruptcy rule and that it does not "supplement" existing law and rules but alone speaks to the authority of bankruptcy judges and their relationship with the district court.

> The process by which local rules are made is satisfactory if, as the draftsmen of Civil Rule 83 expected, the local rules are confined to such matters as the procedure for admission of attorneys, the day on which motions will be heard, and whether to have the clerk's office open on Saturday mornings. It is wholly unsatisfactory as a means of dealing with . . . difficult and controversial topics . . . (Wright & Miller, *Federal Practice and Procedure: Civil*, §3152, p. 220.)

Although promulgated by the district courts as a local rule, the model rule was proposed and recommended by the Administrative Office of the United States Courts for adoption uniformly in all of the judicial districts to provide for the "continued operation of the bankruptcy court system."[115] This seems to be a matter of a general nature not dealt with elsewhere and not of the particularities of practice or procedure. "Basic procedural innovations are not the proper subject of local rulemaking." [115a] Since 927 and FRCP 83 are effectively, alter egos, that which is seen as a limitation upon the district court's civil rulemaking authority under FRCP 83 should also be seen as a limitation upon that authority under Rule 927. FRCP 83 only provides a source of judicial authority when other rules are inapplicable.[116]

Since the FRCP, as such, are inapplicable in bankruptcy[117] and there is no other Bankruptcy Rule dealing with the general authority of bankruptcy judges, is it that Rule 927 is merely an inappropriate basis for the model rule but not an improper one, or is it improper because the model rule promulgated under the apparent authority of Rule 927 is not "consistent with Acts of Congress and rules of practice and procedure prescribed by the Supreme Court."[118]

There can be no question that the model rule does not deal with a matter "confined . . . to minor housekeeping details."[119] There can be no question that the model rule does deal with a matter of general national concern to the continued operation of the bankruptcy court system. In this respect, a rule dealing with a matter such as is the subject of the model rule would appear to have to be promulgated by general rule pursuant to 28 U.S.C. §2075.

That the rule should have been promulgated pursuant to the authority of 28 U.S.C. §2075 follows from two characteristics of the model rule: (1) it deals in a general way with a bankruptcy matter, and (2) a rule promulgated pursuant to an authority or by a process other than that established by 28 U.S.C. §2075 would perforce be a rule inconsistent with an Act of Congress if it did deal in a general way with a bankruptcy matter. (It may also be an attempt to deal with a non-bankruptcy matter via the bankruptcy rules.[120]) If the nature and import of the model rule does fall within the scope of 28 U.S.C. §2075, can the Supreme Court delegate this rulemaking function to a lesser federal court? And, if there can be such a delegation, mustn't it be accomplished through some formal expression by the Supreme Court of that delegation—in contrast with the process by which the model rule was developed by the Administrative Office?[121]

It would appear that 28 U.S.C. §2075 effects a preemption in favor of the Supreme Court of the United States the bankruptcy rulemaking authority when general matters of practice and procedure are concerned. However, if that authority is delegable to the district court, the district court would seem to have to act pursuant to its general rulemaking authority granted by 28 U.S.C. §2071.[122] The limitation upon rulemaking con-

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110. Appendix A, *supra*, note 14.
111. Pub.L. 95-598, §405(d).
112. Appendix A, *supra* note 14 (at § g).
113. 1981 *Collier* Pamphlet Edition, *Bankruptcy Rules*, p. 9.
114. §2075. Bankruptcy rules.

    The Supreme Court shall have the power to prescribe by general rules, the forms of process, writs, pleadings, and motions, and the practice and procedure in cases under title 11.

    Such rules shall not abridge, enlarge, or modify any substantive right.

    Such rules shall not take effect until they have been reported to Congress by the Chief Justice at or after the beginning of a regular session thereof but not later than the first day of May and until the expiration of ninety days after they have been thus reported.
115. Appendix B, *supra*, note 15.
115a. *See Miner V. Atlass*, 363 U.S. 641 (1960).
116. *See*, *Brown v. Cameron-Brown Co.*, 652 F.2d 375 (CA-4, 1981).
117. *Supra*, note 91.
118. Cf. 28 U.S.C. §2075, *supra* note 114.
119. Wright and Miller, *Federal Practice and Procedure: Civil*, §3153, p. 224.
120. *Supra*, note 78 and accompanying text.
121. *See*, Appendix B, *supra*, *note 115*, *and compare* 28 U.S.C. §2075, *supra*, note 114.
122. *Supra*, note 92.

tained in that provision is that rules promulgated in respect thereto "shall be consistent with Acts of Congress and rules of practice and procedure prescribed by the Supreme Court."[123]

If the model rule has been properly characterized,[124] then the question may be whether or not, if the rule is promulgated pursuant to some authority other than 28 U.S.C. §2075, such as 28 U.S.C. §2071, it is a rule that does not violate the central qualification of that authority, that the rule be "consistent with Acts of Congress and rules of practice and procedure prescribed by the Supreme Court."[125] However, if the model rule does comport with that qualification, nevertheless it may not be within the ambit of 28 U.S.C. §2071 because it is not a rule "for the conduct of . . . [the district court's] business."[126]

A rule that is promulgated "for the conduct of . . . business"[127] may have as its subject one of a wide range of matters.[128] Arguably, however, that which is intended by that language is a rule that governs procedure, not the authority of a judicial officer to act or the nature of the powers such an officer may exercise. There are many federal judicial officers appointed other than pursuant to Article III of the Constitution,[129] in all but one of those cases the authority of that officer is specified by statute.[130] The authority of a judicial officer to act probably can be invested only by statute. Certainly this seems to have been what the Supreme Court was saying in *Northern Pipeline*.[131] And, notwithstanding the Reform Act intended to accomplish such a purpose insofar as bankruptcy judges are concerned, the invalidation of that provision by the Court in *Northern Pipeline* probably cannot be the basis for an investiture of authority in a judicial officer other than by statute even if it is attempted by a (local) rule of court intended only "to be an interim measure".[132]

Even though we have questioned the validity of the model rule's predicate, i.e., the Judicial Conference's opinion "that the Supreme Court decision [in *Northern Pipeline*] did not completely invalidate subsections (a) and (b) of section 1471 of Title 28, United States Code,"[133] if there is some accuracy to that opinion it may also be that "the authority of the bankruptcy judges . . . to act in bankruptcy cases and proceedings"[134] has not entirely been abrogated by *Northern Pipeline*. If that is the case, such residual authority itself must be the frame of reference against which to determine the validity of the model rule as a "gap-filler". Therefore, whatever the ultimate source of authority for the promulgation of the model rule, clearly it could not be inconsistent with Pub.L. 95-598.

Unfortunately, however, there is no language in any of the opinions in *Northern Pipeline* or the model rule or its accompanying memorandum with respect to which the extent of such residual authority can be determined. Moreover, the model rule does not indicate whether it is intended to be the complete expression of bankruptcy judges' authority to act in bankruptcy cases and proceedings. However, because of several matters dealt with in the model rule—as will be seen hereafter[135]—it is arguable that the model rule does intend *vel non* to be the source of authority for bankruptcy judges to act. Not only would such a purpose for the model rule have to be validated with reference to the intent and meaning of the extent of invalidation of Pub.L. 95-598, §241(a) by *Northern Pipeline*—an exercise that would test the powers of the Delphic Oracle[136]—but this also would further tend to confirm that such a purpose is not "to prescribe rules for the conduct of . . . [the district court's] business."[137]

It is interesting to note that the model rule is put forth as an authoritative statement of the extent to which the continued force and effect of the Reform Act and the Bankruptcy Rules are to be determined.[138] As we have seen, all of the provisions of statute and rule which authorize the promulgation of rules impose as a limitation upon the validity of such rules that they be consistent with Acts of Congress. Additionally, certain rules also must not be inconsistent with other rules. It is almost as if the model rule is intended to be read as though it contained a variation of the now repealed (former) last sentence of 28 U.S.C. §2075.[139]

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[123] *Id.*

[124] I.e., (1) It deals in a general way with a bankruptcy matter; and (2) a rule promulgated pursuant to an authority or by a process other than that established by 28 U.S.C. §2075 would perforce be a rule inconsistent with an Act of Congress.

[125] 28 U.S.C. §2071, *supra*, note 92.

[126] *Id.*

[127] *Id.*

[128] *Hecker v. Fowler*, *supra* note 78.

[129] Cf. *Glidden v. Zdanok*, 370 U.S. 530 (1962).

[130] Cf. FRCP 53.

[131] 102 S. Ct. 2867-2874.

[132] Appendix B, *supra* 15, at p. 2.

[133] *Id.*

[134] Appendix A, *supra* note 14.

[135] Referral and District Court Review, *infra*.

[136] *See*, Vihon, *Analysis of Northern Pipeline*, 87 COMM. L. J. 397 (1982).

[137] 28 U.S.C. §2071, *supra*, note 92.

[138] Cf. Appendix A, *supra*, note 14, at §(g).

[139] "All laws in conflict with such rules shall be of no further force or effect after such rules have taken effect." *See*, Pub.L. 95-598, §247(2).

Delegation of Authority: Referral

The model rule provides for the "referral of bankruptcy cases to the bankruptcy judges."[140] There is no need for this to appear in the rule:

> "All cases commenced under title 11 . . . during the transition period shall be referred to the United States bankruptcy judges.[141]

Moreover, as if that were not adequate enough basis for referral, Rule 102 provides that "Upon the filing of a petition the clerk shall refer the case forthwith to a referee . . . ."[142] The existence of these other sources of authority for referral and the failure of the model rule to make any mention or reference to them in connection with referral strongly suggests that what is intended is that the model rule is the basis for the referral process and procedure to the exclusion of the other references. That this is intended also is strongly suggested by the fact that the referral process as presented by the model rule conflicts with that of the Reform Act and the Rules. Apparently there is the desire to avoid the spirit and letter of referral as it would exist pursuant to Pub.L. 95-598, §404(a).

Under the Reform Act, referral would be of all cases under title 11 and all proceedings in those cases except:

> "(A) a proceeding to enjoin a court;
> (B) a proceeding to punish a criminal contempt—
> (i) not committed in the bankruptcy judge's actual presence; or
> (ii) warranting a punishment of imprisonment; or
> (C) an appeal from a judgment, order, decree, or decision of a United States bankruptcy judge."[143]

Under the model rule, however, "the bankruptcy judge may not conduct:

> (A) a proceeding to enjoin a court;
> (B) a proceeding to punish a criminal contempt—
> (i) not committed in the bankruptcy judge's actual presence; or
> (ii) warranting a punishment of imprisonment;
> (C) an appeal from a judgment, order, decree, or decision of a United States bankruptcy judge; or
> (D) jury trials."[144]

Those provisions are identical in almost all respects: the model rule but not the Reform Act would prohibit the bankruptcy judge from conducting jury trials.

Why the model rule would prohibit bankruptcy judges from conducting jury trials is not discussed. There is nothing in *Northern Pipeline* to suggest that the bankruptcy judge's authority to conduct a jury trial was of any consideration to the Court. Indeed, it was only *after* it had concluded that the Reform Act invested in bankruptcy judges a "broad grant of power" that it was observed that bankruptcy judges also had "the power to hold jury trials".[145]

Possession of the authority to conduct jury trials is nothing new to bankruptcy judges. Under §19 of the (former) Bankruptcy Act[146]—and Rule 115[147]—jury trials were (and are) provided for. Indeed, with respect to the issues of insolvency and commission of an act of bankruptcy, where an involuntary petition had been filed against a person, that person had an absolute right to have those issues tried by a jury. It is obvious that comparable treatment is given under the Reform Act, more particularly to be exercised by the bankruptcy court, where it is provided that "the issues arising under section 303 of title 11 . . . (may) be tried without a jury."[148] Such a provision would not be necessary if a jury trial by the bankruptcy judge were not contemplated. Also, denial to the bankruptcy judge by the model rule of the authority to conduct jury trials certainly is inconsistent with the "limited invalidity" thesis of the model rule.[149]

A patent inconsistency is indicated by there being no limitation in Pub.L. 95-598, §405(a) of the bankruptcy judge's authority to conduct jury trials while such a limitation is contained in the model rule. As earlier discussed, by whatever authority the model rule is sought to be justified, there can be no validity in the rule to whatever extent it is inconsistent with an Act of Congress.

Once the referral is effected, it nevertheless may be "withdrawn by the district court at any time on its own motion or on timely motion by a party."[150] There is no limitation on the (type of) matter subject to this withdrawal of reference—nor is there any standard that has to be met, reason given or procedure adhered to. All that is indicated is that if a withdrawal is to be effected other than by the district court *sua sponte*, it must be "on timely motion by a party."[151]

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[140] Appendix A, *supra*, note 14.

[141] Pub.L. 95-598, §404(a).

[142] Bankruptcy Rule 102(a).

[143] Pub.L. 95-598, §405(a)(1).

[144] Appendix A, *supra*, note 14, at 3(d).

[145] 102 S.Ct. 2863.

[146] §19. Jury trials. a. A person against whom an involuntary petition has been filed shall be entitled to have a trial by jury in respect to the question of his insolvency . . . and of any act of bankruptcy alleged in such petition to have been committed . . . .

[147] (1) An alleged bankrupt may . . . demand a trial by jury of any issue triable of right by a jury under §19a of the Act . . .

[148] 28 U.S.C. §1480(b).

[149] *See* Appendix B, *supra*, note 15, at p. 2.

[150] Appendix A, *supra*, note 14, at 3(c)(2).

[151] *Id.*

Ostensibly, the provision for reference in Pub.L. 95-598, §405(a) and the provision in 28 U.S.C. §1471(c), before *Northern Pipeline*, effected a supercession of Rule 102[152]—particularly subsection (b) thereof. However, with the invalidation of Pub.L. 95-598, §241(a) and 28 U.S.C. §1471(c) with it, Rule 102 may have become revitalized. If so, the model rule is in conflict with it for several reasons.

There is a standard governing withdrawal of reference pursuant to Rule 102(b), *viz.*, "for the convenience of the parties or other cause".[153] Certainly the quoted language is neither unique nor uninterpreted in federal case lore.[154] It is a substantive test the conditions for which must be satisfied before the reference may be withdrawn.[155] That "cause" must exist to withdraw a matter from the bankruptcy judge certainly does more than simply suggest that the Rules contemplate that the bankruptcy judge will hear and adjudicate matters referred to it. With no provision in the model rule for any (comparable or other) standard for the withdrawal of the reference, one is hard-pressed to conclude that the rule really intends the bankruptcy judge to hear any matter; at the least, there is a conflict between the model rule and the Bankruptcy Rule. Since the latter has been promulgated by the Supreme Court and local rules must be consistent therewith, in this respect it would appear that the model rule would have to fall.

Under the model rule, withdrawal of the reference if other than by the district court *sua sponte* is to be by a party upon "timely motion".[156] Standards for timeliness also have not been provided. But, it is hard to imagine why the requirement of timeliness was included when the withdrawal can be effected "at any time".[157] (Since timing of a withdrawal of the reference and consideration of such a withdrawal matter by the district court might be tantamount to review on appeal, this aspect of withdrawal will be considered further in connection with the model rule's provision for appeals.[158])

Withdrawal by a party must be by motion.[159] Rule 102(b) contains no comparable specification of procedure; however, local rules probably allowed such a matter to come up by application[160]—or at least by some procedure less formal than that now being required by the model rule. The requirement of motion with respect to withdrawal of the reference requires that this matter be treated as a contested matter,[161] as a separate proceeding attendant upon some semblance of formality. It is difficult to understand why the more formalized procedure is required by the model rule in the face of the model rule's treatment of the relationship between the bankruptcy judge and the district court as one of total subordination. In any event, here too the model rule is in conflict with the existing Rules.

When the reference has been withdrawn, under the model rule the district court may (1) retain the entire matter, (2) refer part of the matter back to the bankruptcy judge or (3) refer the entire matter back to the bankruptcy judge with instructions.[162] Moreover, withdrawal requires reassignment to another district judge.[163] Rule 102(b), on the other hand, does not allow the district judge to refer the entire matter back to the bankruptcy judge with instructions or require that upon withdrawal of the reference there be a reassignment to another district judge. In its Note, the Advisory Committee indicates that re-referrals to the same bankruptcy judge are contemplated (only) "If the reason for assignment or withdrawal ceases to be operative."[164]

Referral under the model rule is predicated upon the asserted existence of "exceptional circumstances". Whatever the authority might be upon which promulgation of the model rule is based, there is nothing that faintly resembles the requirement that such a condition exist as the predicate for the exercise of the rulemaking function or the referral of matters from a district court to a bankruptcy judge. As a matter of fact, the only place where referral is treated as exceptional is in the provision for masters under FRCP 53: "a reference to a master shall be the exception not the rule . . . a reference shall be made only upon a showing that some exceptional condition requires it."[165]

FRCP 53 recognizes that a referee can be a master, or *vice versa*.[166] Additionally, the provisions in FRCP 53 are, in some respects, quite similar to some of those of the model rule and in those respects constitute the only place in statute or rule where provisions comparable to those of the model rule will be found. For example, "The order of reference to the master may specify or limit his powers". Even the Bankruptcy Rules contemplate that a matter may be referred to a master.[167] A comparison of the overall import of the model rule and the relationship it establishes between the bankruptcy judge and the district court, with the treatment of the bankruptcy judge and the district court under the Reform Act—even under the Bankurptcy Rules—lends strong suspicion to a conclusion that the model rule is an attempt to make an *en masse* appointment of bankruptcy judges as masters.[168] If that is the case, such a delegation of authority under those circumstances raises few questions.[169] However, the standards that should obtain under such circumstances to govern the relationship between a master and the district court and the procedures a master would be required to respect would flow not from the model rule or the Bankruptcy Rules but from FRCP 53.[170]

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[152] "The district judge may, at any time, for the convenience of parties or other cause, withdraw a case in whole or in part from a referee and either act himself or assign the case or part thereof to another referee in the district." Bankruptcy Rule 102(b).

[153] *Id.*

[154] *See*, 17 Words and Phrases 344 *et. seq.* (Re: "for cause"), and 9? Words and Phrases 112 (Re: "convenience of parties").

[155] *See In re Holland*, 411 F.Supp. 730 (D.C. E.D.Wis. 1976).

[156] Appendix A, *supra*, note 14, at §(c)(2).

[157] *Id.*

[158] *Infra.*

[159] Appendix A, *supra*, note 14, at §(e)(2).

[160] *See*, for example, local Rule 19, SDNY.

[161] *See*, Bankruptcy Rule 914.

[162] *Supra*, note 159.

[163] *Id.*

[164] Advisory Committee's Note, Bankruptcy Rule 102.

[165] Fed.R.Civ.P. 53(b).

[166] Fed.R.Civ.P. 53(a).

[167] Bankruptcy Rule 513.

District Court Review

Of all the provisions in the model rule that seem at odds with Congressional intent, which go far beyond dealing simply with practice or procedure and which fundamentally change one or another of the provisions or characteristics of the Reform Act, the provision for district court review[171] seems most obvious. Cast in terms of an appellate procedure to create what would be expected to be a trial-appellate relationship between the bankruptcy judge and the district court, this provision nevertheless clearly seems to deny that relationship. The ordinary trial-appellate relationship probably best can be characterized in terms of the deference given by the appellate court to the determinations of the lower court.[172] Such determinations usually will not be disturbed unless they are found to be clearly erroneous.[173] This, however, is not so under the model rule: "the district judge . . . need give no deference to the findings of the bankruptcy judge."[174] This, in connection with the provision for withdrawal of the reference, makes it likely that under the model rule there would lack not just a true appellate process but an effective decision-making role for the bankruptcy judge.

The fact that the reference of a matter to the bankruptcy judge may be withdrawn at any time for any or no reason[175] suggests that this context rather than the trial-appellate relationship will be that which obtains between the bankruptcy judge and the district court. The former requires merely a timely motion by a party.[176] However, even if there is a viable, more formal, appellate procedure, it is not likely that a party, believing it would be better for the district court to decide the matter, would wait for a bankruptcy judge to make an adverse decision. What is more likely is that such party will see how things are going but move to withdraw the reference before the bankruptcy judge acts.

Since there is no deference the district court must give to the decisions of a bankruptcy judge, good advocacy will always favor "two bites at the apple" when it appears that things are not going favorably.[178] This is especially true when considerations of cost suggest that it is more economical to cut short the bankruptcy judge's consideration of the matter to allow for beginning anew at the district court level. Indeed, in this respect it is more likely that the bankruptcy judge will not even have much of a chance to consider a matter.

The appellate process established by Pub.L. 95-598[179] allowed for review of bankruptcy judges' final decisions—according to the "clearly erroneous standard" under Rule 810—[180] by the court of appeals, if the parties concurred, or by either the district court or a bankruptcy appellate panel.[181] During the transition period this structure is provided pursuant to Pub.L. 95-598, §405(c),[182] a provision not within any of the prescriptive statements or the judgment of the Supreme Court in *Northern Pipeline*. Consequently, unless the model rule somehow can have the force and effect of legislation overriding the Reform Act, it is difficult to understand how any provision in the model rule for an appellate process can be valid.

In another respect the model rule clearly abrogates the Reform Act: it is impossible under the model rule for there to be appeals directly to the courts of appeals[183] or for there to be bankruptcy appellate panels.[184] Only review by the district court is provided. Once again, there is no suggestion in anything stated by any Justice in *Northern Pipeline* that the bankruptcy appellate process generally or any specific element of it under the Reform Act or any one or more of Pub.L. 95-598, §§201, 236, 237, 238, 240 or 405[185] was of questionable validity or invalid.

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168. Cf. Fed.R.Civ.P. 53(1)(2).
169. *Generally*, the model rule's withdrawal from the bankruptcy judge of independent powers places the bankruptcy judge virtually in the same position *vis-a-vis* the district court as is a master.
170. *Accord:* Bankruptcy Rule 513.
171. Appendix A, *supra*, note 14, at §(d).
172. *See, generally*, James and Hazard, *Civil Procedure*, §13.7, p. 675 *et. seq.*; and Green, *Basic Civil Procedure*, §6, p. 276, *et. seq.*
173. *See, for example*, Bankruptcy Rule 810.
174. Appendix A, *supra*, note 14, at §(e)(2)(B).
175. *Supra*, note 150.
176. *Id.*
178. Cf. Model Code of Professional Responsibility, EC7-1, EC7-19 and DR7-101(A)(1).
179. *Supra*, notes 41, 42, 43 and 44.
180. ". . . the court shall accept the referee's findings of fact unless they are clearly erroneous . . ."
181. *Supra*, note 179.
182. *Supra*, note 44.
183. *See*, Appendix A, *supra*, note 14, at §(e).
184. *Id.*
185. §201 provides for appellate panels; §236 provides for appeals to courts of appeals; §237 provides for circuits in which decisions are reviewable; §238 provides for appeals to district courts; §240 provides for districts in which decisions are appealable; and §405 is the appellate process during the transition period.

It is equally difficult to understand how the model rule can override or supercede provisions in the Bankruptcy Rules where *Northern Pipeline* does not in any way bear upon the matter. The model rule purports to validate Part VIII of the Rules but then says that the Rules are "modified by . . . this rule".[186]

(Former) Bankruptcy Act §2a(7)[187] and Rule 915(a)[188] established jurisdiction by consent. In the face of the time-worn epigram that jurisdiction cannot be created by consent of the parties where such jurisdiction otherwise did not exist,[189] jurisdiction by consent under the (former) Act was a function of a specific provision of the statute and, therefore, supportable under 28 U.S.C. §1331.[190] On appeal of a matter arising under the (former) Act, a party was estopped from raising the question of jurisdiction where it had not timely been raised below, pursuant to the statute.[191] The model rule attempts to recreate a similar circumstance: a party would be estopped from raising the issue of the bankruptcy judge's lack of authority to issue a final order if the party failed to raise the question "prior to the time of the entry of the order or judgment of the district court after review".[192]

Miscellaneous

Among the "exceptional circumstances" found to exist as the basis for promulgation of the model rule is that the finding unconstitutional of the grant of power to bankruptcy judges was "unanticipated". This could hardly have been the case; even the Supreme Court noted in *Northern Pipeline* that extensive consideration was given to the matter of court structure and jurisdiction by both Houses of Congress during their respective legislative processes.[193] Moreover, it is hard to characterize as "exceptional circumstances" that Congress wished bankruptcy jurisdiction to be exercised by bankruptcy judges and that they should possess specialized knowledge and experience. Both of these matters were discussed and considered during the legislative history of Pub.L. 95-598.[194] Such rationalizations are unseemly in this context and at this time.

The model rule allows the "bankruptcy court constituted by §404 of Public Law 95-598 . . . [to] continue to be known as the United States Bankruptcy Court . . ."[195] There is no bankruptcy court constituted by that section; there is only the continuation during the transition period of the district court as the "court of bankruptcy",[196] a designation carried over from the (former) Bankruptcy Act).[197] It is not until April 1, 1984, that there comes into existence an entity then to be known as the United States Bankruptcy Court.[198]

As the "court of bankruptcy", the district court sits in bankruptcy as a department separate from the other departments of the district court represented by the other types of subjects over which it has jurisdiction.[199] This is a far cry from an authorization, creation or justification of a "United States Bankruptcy Court". Nothing in Pub.L. 95-598 authorizes or supports such conclusions. Where the model rule derives such position is indeterminable—but it is consistent with other aspects of the rule whereby modification of Acts of Congress and other rules of procedure are attempted.

The model rule allows a bankruptcy judge's order or judgment to be temporized by a stay entered by the bankruptcy judge or a district judge.[200] However, it is only in connection with an appeal that such order or judgment is temporized under Rule 803[201] and Interim Rule 8006[202] (except, of course, to the extent that FRCP 62 is applicable).[203]

Related Proceedings[204]

Left for the end is the remarkable attempt the model rule makes to interpret the contours of the judgment in *Northern Pipeline*. It is clear that a tribunal constituted pursuant to Article I of the Constitution may hear and adjudicate without breaching the barrier which requires that only Article III courts may exercise the judicial power of the United States.[205] The clarity of this conclusion does not depend upon the reasoning or the judgment in *Northern Pipeline*; it was a principle that unqualifiedly antedated that decision.[206] *Northern Pipeline* presumably has fleshed-out that line of demarcation. If so, it is not possible to determine this from the laundry list of related proceedings developed in the model rule, much less whether that line can be demarcated successfully by whatever the exercise or context. Because we have concluded that such exercise would require the powers of the Delphic Oracle,[207] no attempt has or will be made to take the bait to do so.

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[186] Appendix A, *supra*, note 14, at §(c)(1).

[187] ". . . where in a controversy arising in a proceeding under this act an adverse party does not interpose objection to the summary jurisdiction of the court of bankruptcy . . . he shall be deemed to have consented to such jurisdiction . . . ."

[188] ". . . A party waives objection to jurisdiction of an adversary proceeding or a contested matter and thereby consents to such jurisdiction if he does not make objection . . . ."

[189] See cases cited at 1 *Moore's Federal Practice*, ¶0.60[4], p. 624, note 2.

[190] *Supra*, note 83.

[191] *Supra*, notes 187 and 188.

[192] Appendix A, *supra*, note 14, at §(c)(4).

[193] 102 S. Ct. 2866, at note 12.

[194] H. Rep., *supra*, note 4, at pp. 13-22, and S. Rep., *supra* note 57, at pp. 15-18.

[195] Appendix A, *supra*, note 14, at §(b).

[196] Pub.L. 95-598, §404(a).

[197] See, letter of Joseph E. Fried in H.Rep. 97-807, 97th Cong. 2nd Sess. 44-48.

[198] Pub.L. 95-598, §§201 and 402(b).

[199] *Supra*, note 197.

[200] See, Appendix A, *supra*, note 14, at §(c)(2).

[201] "Unless a notice or appeal is filed . . . the judgment or order of the referee shall become final."

[202] "Unless a notice or appeal is filed as prescribed by Rules 801 and 802 of the Bankruptcy Rules . . . the judgment or order of the bankruptcy judge shall become final."

[203] RE: Stay of Proceedings to Enforce a Judgment.

[204] See, Appendix A, *supra*, note 14, at §(d)(3)(A).

[205] See, *Northern Pipeline*, *supra*, note 6.

[206] *Id.*

It does not, however, require much insight or craftsmanship to observe that any attempt at such laundry-list-making will be fraught with danger. If this or that type of matter does or does not fall within the class of case but for which *Northern Pipeline* would not have successfully invalidated the jurisdictional grant to bankruptcy judges will be a determination suspect until the Supreme Court—or Congress—speaks to the matter again. Consequently, the best that can be said about the model rule's provision for related proceedings is that it is questionable.

Even using the summary-plenary distinction required by the (former) Bankruptcy Act[208] is of no significance, since even that scheme was not a classificatory one; it was a *post hoc* observation.[209]

Northern Pipeline had to deal with a jurisdictional scheme represented by four types of cases or proceedings.[210] There is nothing in the model rule that ties one or more of the related proceedings to that typology nor is there anything in *Northern Pipeline* that would so allow.

Conclusion

The model rule lacks fidelity to the purposes and intent of the Bankruptcy Reform Act and seeks to read into the Supreme Court's decision in *Northern Pipeline* the requirement that unless Congress restructures the power and authority of bankruptcy judges the bankruptcy system may constitutionally only be administered by the district courts, and they in turn, therefore, may, through some form of rulemaking, provide for the delegation of their authority in any manner they choose. It relegates sitting bankruptcy judges to the status of judicial officer no greater than that of a master, not even to the level of magistrate.

Constitutionally, the rule sits upon a most precarious base. It has been promulgated outside the authority and according to which such rules may be promulgated and it deals with a number of matters in conflict with Acts of Congress and other rules of general application. It is vexatious at best by dealing with matters dealt with elsewhere and by dealing with them differently and inconsistently, so that the overall impression is of confusion and irresponsibility.

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[207] *Supra*, note 136.

[208] *See*, *generally*, 2 *Collier on Bankruptcy* ¶ 23.02 *et seq.*

[209] *See* [illegible], *supra*, note 136 at 404.

[210] *Supra*, note 80.

ADMINISTRATIVE OFFICE OF THE
UNITED STATES COURTS
WASHINGTON, D.C. 20544

WILLIAM E. FOLEY
DIRECTOR

JOSEPH F. SPANIOL, JR.
DEPUTY DIRECTOR

December 3, 1982

MEMORANDUM TO ALL:
Judges, U.S Courts of Appeals
Judges, U.S. District Courts
Judges, U.S. Bankruptcy Courts
Clerks, U.S. District Courts
Clerks, U.S. Bankruptcy Courts

SUBJECT: Continued Operation of the Bankruptcy Court System after December 24, 1982, in the Absence of Congressional Action

On September 27, 1982, I transmitted by memorandum a model rule and sample order in accordance with the following September 23, 1982 Resolution of the Judicial Conference:

> RESOLVED:
>
> That the Conference request the Director to provide each circuit with a proposed rule to take effect October 5, 1982 in the absence of congressional action or extension of the stay, which rule will permit the bankruptcy system to continue without disruption in reliance upon jurisdictional grants remaining in the law as limited by Northern Pipeline Construction Co. v. Marathon Pipe Line Co. et al.

My September 27, 1982 transmission was, of course, designed to provide a "contingency approach," as specified in the Conference's Resolution, "in the absence of Congressional action or extension of the stay," then scheduled to expire on October 4. As you know, the Supreme Court, on October 4 extended the stay until December 24, because Congress was not able to act before recessing on October 2.

Congress reconvened on November 29, five days ago. While efforts to take action are now being made by the Congress, I believe prudence requires that I again provide "a proposed rule ... which ... will permit the bankruptcy system to continue without disruption" should Congress be unable to act -- or if the stay is not again extended -- by December 24.

In Northern Pipeline Construction Co. v. Marathon Pipe Line Co., et al., 102 S.Ct. 2858 (1982) the Supreme Court found that certain powers assigned to bankruptcy judges by the 1978 Bankruptcy Reform Act could be exercised constitutionally only by Article III judges, that language in the Act conferring unconstitutional authority could not be severed from language conferring other powers, and therefore provided the opportunity for Congress to correct the jurisdictional problem.

The Conference on September 10, 1982, advised Congress of its belief that the Supreme Court decision did not completely invalidate subsections (a) and (b) of section 1471 of Title 28, United States Code, as enacted in section 241(a) of the 1978 Act. In addition, sections 404 and 405 of that Act expressly vest bankruptcy powers in the district courts as "courts of bankruptcy" until April 1, 1984. The attached model rule has been formulated in reliance upon the remaining valid elements in the 1978 Act.

The attached model rule is intended to be an interim measure, by which district courts may delegate many of their bankruptcy powers to bankruptcy judges. The authority for that delegation is found in section 105 of the 1978 Act, which gives courts of bankruptcy the power to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title," and in Bankruptcy Rule 927, which gives bankruptcy courts the power to adopt "rules governing practice and procedure under the Act."

Under the model rule, all bankruptcy matters are initially referred to a bankruptcy judge. [Section b(1) of the Rule.] In proceedings not involving a final judgment on a Marathon claim, the bankruptcy judge may enter orders and judgments that become effective immediately, subject to district court review if requested by a party. [Section (c)(2).] With respect to final judgments in Marathon claims, the bankruptcy judge prepares recommended findings and conclusions and a proposed judgment. [Section (c)(3).] A district judge then reviews the recommendation and enters a judgment. [Section (c)(5).] Where the bankruptcy judge certifies that circumstances require, an order or judgment entered by a bankruptcy judge will be confirmed by a district judge even if no objection is filed.

The district court will provide expedited review or confirmation of any order, judgment, or proposed judgment where the bankruptcy judge certifies prompt review is necessary.

William E. Foley

Attachments: Model Rule
Sample Order

"The Rule"

Administration of Bankruptcy System

(a) Emergency Resolution

The purpose of this rule is to supplement existing law and rules in respect to the authority of the bankruptcy judges of this district to act in bankruptcy cases and proceedings until Congress enacts appropriate remedial legislation in response to the Supreme Court's decision in *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, ____ U.S. ____, 102 S. Ct. 2858 (1982), or until March 31, 1984, whichever first occurs.

The judges of the district court find that exceptional circumstances exist. These circumstances include: (1) the unanticipated unconstitutionality of the grant of power to bankruptcy judges in section 241(a) of Public Law 95-598; (2) the clear intent of Congress to refer bankruptcy matters to bankruptcy judges; (3) the specialized expertise necessary to the determination of bankruptcy judges; (3) the specialized expertise necessary to the determination of bankruptcy matters; and (4) the administrative difficulty to the district courts' assuming the existing bankruptcy caseload on short notice.

Therefore, the orderly conduct of the business of the court requires this referral of bankruptcy cases to the bankruptcy judges.

(b) Filing of Bankruptcy Papers

The bankruptcy court constituted by §404 of Public Law 95-598 shall continue to be known as the United States Bankruptcy Court of this district. The Clerk of the Bankruptcy Court is hereby designated to maintain all files in bankruptcy cases and adversary proceedings. All papers in cases or proceedings arising under or related to Title 11 shall be filed with the Clerk of the Bankruptcy Court regardless of whether the case or proceeding is before a bankruptcy judge or a judge of the district court, except that a judgment by the district judge shall be filed in accordance with Rule 921 of the Bankruptcy Rules.

(c) Reference to Bankruptcy Judges

(1) All cases under Title 11 and all civil proceedings arising under Title 11 or arising in or related to cases under Title 11 are referred to the bankruptcy judges of this district.

(2) The reference to a bankruptcy judge may be withdrawn by the district court at any time on its own motion or on timely motion by a party. A motion for withdrawal of reference shall not stay any bankruptcy matter pending before a bankruptcy judge unless a specific stay is issued by the district court. If a reference is withdrawn, the district court may retain the entire matter, may refer part of the matter back to the bankruptcy judge, or may refer the entire matter back to the bankruptcy judge with instructions specifying the powers and functions that the bankruptcy judge may exercise. Any matter in which the reference is withdrawn shall be reassigned to a district judge in accordance with the court's usual system for assigning civil cases.

(3) Referred cases and proceedings may be transferred in whole or in part between bankruptcy judges within the district without approval of a district judge.

(d) Powers of Bankruptcy Judges

(1) The bankruptcy judges may perform in referred bankruptcy cases and proceedings all acts and duties necessary for the handling of those cases and proceedings except that the bankruptcy judges may not conduct

- (A) a proceeding to enjoin a court;
- (B) a proceeding to punish a criminal contempt—
  - (i) not committed in the bankruptcy judge's actual presence, or
  - (ii) warranting a punishment of imprisonment.
- (C) an appeal from a judgment, order, decree, or decision of a United States bankruptcy judge, or
- (D) jury trials.

Those matters which may not be performed by a bankruptcy judge shall be transferred to a district judge.

(2) Except as provided in (d)(3), orders and judgments of bankruptcy judges shall be effective upon entry by the Clerk of the Bankruptcy Court, unless stayed by the bankruptcy judge or a district judge.

(3) (A) Related proceedings are those civil proceedings that, in the absence of a petition in bankruptcy, could have been brought in a district court or a state court. Related proceedings include, but are not limited to, claims brought by the estate against parties who have not filed claims against the estate. Related proceedings do not include: contested and uncontested matters concerning the administration of the estate; allowance of and objection to claims against the estate; counterclaims by the estate in whatever amount against persons filing claims against the estate; orders in respect to obtaining credit; orders to turn over property of the estate; proceedings to set aside preferences and fraudulent conveyances; proceedings in respect to lifting of the automatic stay; proceedings to determine dischargeability of particular debts; proceedings to object to the discharge; proceedings in respect to the confirmation of plans; orders approving the sale of property where not arising from proceedings resulting from claims brought by the estate against parties who have not filed claims against the estate; and similar matters. A proceeding is not a related proceeding merely because the outcome will be affected by state law.

(B) In related proceedings the bankruptcy judge may not enter a judgment or dispositive order, but shall submit findings, conclusions, and a proposed judgment or order to the district judge, unless the parties to the proceeding consent to entry of the judgment or order by the bankruptcy judge.

(e) District Court Review

(1) A notice of appeal from a final order or judgment or proposed order or judgment of a bankruptcy judge or an application for leave to appeal an interlocutory order of a bankruptcy judge, shall be filed within 10 days of the date of entry of the judgment or order or of the lodgement of the proposed judgment or order. As modified by sections (e)(2)A and B of this rule, the procedures set forth in Part VIII of the Bankruptcy Rules apply to appeals of bankruptcy judges' judgments and orders and the procedures set forth in Bankruptcy Interim Rule 8004 apply to applications for leave to appeal interlocutory orders of bankruptcy judges. Modification by the district judge or the bankruptcy judge of time for appeal is governed by Rule 802 of the Bankruptcy Rules.

(2) (A) A district judge shall review:

- (i) an order or judgement entered under paragraph (d)(2) if a timely notice of appeal has been filed or if a timely application for leave to appeal has been granted,
- (ii) an order or judgment entered under paragraph (d)(2) if the bankruptcy judge certifies that circumstances require that the order or judgment be approved by a district judge, whether or not the matter was controverted before the bankruptcy judge or any notice of appeal or application for leave to appeal was filed, and
- (iii) a proposed order or judgment lodged under paragraph (d)(3), whether or not any notice of appeal or application for leave to appeal has been filed.

(B) In conducting review, the district judge may hold a hearing and may receive such evidence as appropriate and may accept, reject, or modify, in whole or in part, the order or judgment of the bankruptcy judge, and need give no deference to the findings of the bankruptcy judge. At the conclusion of the review, the district judge shall enter an appropriate order or judgement.

(3) When the bankruptcy judge certifies that circumstances require immediate review by a district judge of any matter subject to review under paragraph (e)(2), the district judge shall review the matter and enter an order or judgment as soon as possible.

(4) It shall be the burden of the parties to raise the issue of whether any proceeding is a related proceeding prior to the time of the entry of the order or judgment of the district judge after review.

(f) Local Rules

In proceedings before a bankruptcy judge, the local rules of the bankruptcy court shall apply. In proceedings before a judge of the district court, the local rules of the district court shall apply.

(g) Bankruptcy Rules and Title IV of Public Law 95-598

Courts of bankruptcy and procedure in bankruptcy shall continue to be governed by Title IV of Public Law 95-598 as amended and by the bankruptcy rules prescribed by the Supreme Court of the United States pursuant to 28 U.S.C. §2075 and limited by SEC. 405(d) of the Act, to the extent that such Title and Rules are not inconsistent with the holding of *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, ____ U.S. ____, 102 S. Ct. 2858 (1982).

(h) Effective Date and Pending Cases

This rule shall become effective December 25, 1982, and shall apply to all bankruptcy cases and proceedings not governed by the Bankruptcy Act of 1898 as amended, and filed on or after October 1, 1979. Any bankruptcy matters pending before a bankruptcy judge on December 25, 1982, shall be deemed referred to that judge

Response of National Conference of Bankruptcy Judges to Testimony of Jonathan C. Rose for the Department of Justice and Honorable Spencer M. Williams for the Federal Judges Association

Submitted by Joe Lee, Chairman, Committee on Legislation
National Conference of Bankruptcy Judges

A recommendation that all litigation related to bankruptcy cases be reassigned to the district courts is difficult to reconsile with the Report of the Senate Judiciary Committee that accompanied the Bankruptcy Reform Act of 1978. Report No. 95-989, 95th Cong., 2d Sess. In that Report, on which the ink is barely dry, the Senate Judiciary Committee noted as follows, at Page 15:

> The need for a functionally independent bankruptcy court has been demonstrated beyond question, first by the study and recommendations of the Commission on Bankruptcy Laws of the United States, by knowledgeable witnesses before the Subcommittee, in published commentary, as well as through long practical experience under the present referee system. A considerable body of opinion has developed in support of the establishment of a bankruptcy court separate from the United States district court, either as an Article III court modeled after the present district court, as a separate Article I court patterned after the U.S. Tax Court, or as a hybrid court consisting of an Article I bankruptcy court appended to an Article III court of bankruptcy appeals.

We now know as a result of the decision of the Supreme Court in Northern Pipeline Construction Co. v. Marathon Pipe Line Co., _____U.S._____, 102 S. Ct. 2858 (1982), that the only viable option of those mentioned above is the first option.

In hearings before this Subcommittee on November 10, 1982, there was unanimous agreement on the part of witnesses that the present functionally independent bankruptcy courts with expanded, unified jurisdiction have performed remarkably well and should be preserved by reconstituting the existing bankruptcy courts as Article III tribunals.

At the hearings on November 10, 1982, Mr. Jonathan C. Rose testified on behalf of the Department of Justice as follows:

> In view of the strong opposition of the Judicial Conference and others to the establishment of an Article III court of specialized jurisdiction for bankruptcy matters, the Department initially had attempted to develop

> an Article I solution that was both workable and constitutional. Unfortunately, our extensive review has led us to the conclusion that we cannot recommend to Congress any Article I solution that is either workable as a practical matter or sufficiently free of constitutional doubt.

Mr. Rose then proceeded to demolish an earlier Article I solution that had been proposed by the Judicial Conference with the following observation:

> Grave constitutional doubts would surround any further temporizing with an Article I solution and would cast a shadow on all bankruptcy cases raising the possibility of a new ruling that such a bankruptcy court structure is unconstitutional. In our judgment, a legislative proposal that simply offers an opportunity for more litigation is no solution at all. . . .

The latest Judicial Conference proposal which the Department unveiled and endorsed at the hearings on January 24, 1983 obviously involves temporizing with an Article I solution, a remedy which the Department has condemned. The Department has attempted to explain its change of position, which Senator Dole described at the hearings as a mid-course correction, on the basis of "comity" between the Executive and Judicial Branches of Government.

It was deference to the notion of "comity" that led the Legislative Branch into error in 1978.

On November 28, 1977 an Ad Hoc Committee of the Judicial Conference advised this Subcommittee as follows:

> [F]rom the standpoint of the constitutionality of the bankruptcy judge assuming increased powers, there was a unanimity in this committee and there was unanimity in the Judicial Conference of the United States that Article III status was not necessary to assume that expanded jurisdiction. Circuit conferees, consisting of every district and every circuit judge within a circuit, have concluded that an Article III judge is not necessary. . . .

See Hearings on S. 2266 and H.R. 8200 Before the Subcommittee on Improvements In Judicial Machinery of the Committee on the Judiciary, United States Senate, 95th Cong., 1st Sess. 411, 413-414 (Nov. 28, 29 and Dec. 1, 1977).

It was this misguided assurance which was supported by the Department of Justice, Hearings on S. 2266 and H.R. 8200, *supra*, at 543-544, that caused Senator DeConcini to believe that a bankruptcy court created as an adjunct of the district court with non-tenured judges could constitutionally exercise the expanded jurisdiction that all agreed was necessary to a sound bankruptcy court system.

The Supreme Court has now told us the Judicial Conference and the Justice Department were wrong in their advice to this Subcommittee in 1978.

In a statement on behalf of the National Bankruptcy Conference appearing in 128 Congr. Rec. H9640 (daily ed. Dec. 13, 1982), Professor Vern Countryman of Harvard Law School describes this latest Judicial Conference proposal involving use of Bankruptcy Administrators and magistrates to handle bankruptcy litigation as constitutionally invalid and even more unworkable than the Emergency Rule under which the bankruptcy courts are now attempting to function.

The Judicial Conference is now telling this Subcommittee that independent bankruptcy courts [the need for which had been demonstrated beyond question in 1978 and which, according to testimony before this Subcommittee on November 10, 1982, are performing superbly] should be abolished and bankruptcy litigation should be reassigned to the district courts, so long as the district courts are provided with the necessary additional personnel, 120 administrators and 50-75 magistrates, so that the district judges will not actually be required to handle bankruptcy litigation except occasionally.

The nine-member Commission on Bankruptcy Laws of the United States, on which Senators Quentin Burdick and Marlow Cook served, examined and rejected as unworkable the option of reassigning bankruptcy litigation to the district courts.

Much of the discussion in the Commission meeting concerning the bankruptcy court structure centered on the treatment bankruptcy cases would receive if placed in the district courts, Commission Minutes, 3, 7-9, 12, 35. Chairman Marsh, Congressman Wiggins, Professor Seligson, and Judge Will all agreed that bankruptcy matters would be placed on the bottom of the district court calendars, id. at 3, 8, 36-37, 44, 46. There was also general consensus that bankruptcy matters would receive "step-child" treatment generally, id. at 36. Judge Will [U.S. District Judge Hubert Will of Chicago, appointed to the Commission by the Chief Justice] favored removal of bankruptcy jurisdiction from the district courts, id. at 18.

The latest Judicial Conference proposal is not only a rehash of a rejected option, it does what the Department of Justice on November 10, 1982 said should be avoided; it offers an opportunity for more litigation because of its questionable constitutionality.

A final point that should be made is that the Supreme Court has not passed on the constitutionality of non-Article III magistrates trying cases, even with the consent of the parties, that involve state created rights, such as was involved in the Marathon case. Professor Countryman asserts that subject matter jurisdiction over such civil actions falling within the judicial power of the United States cannot be conferred upon a non-Article III judicial officer by consent of the parties.

In the concluding paragraph of his dissenting opinion in United States v. Raddatz, 447 U.S. 667, 714 (1980), Mr. Justice Marshall, with whom Mr. Justice Brennan joined, issued this caveat:

> But replacement of Art. III judges with magistrates, even if the replacement extends only to the findings of fact, erodes principles that strike near the heart of the constitutional order. In such contexts considerations of administrative costs are least forceful, and the Court must be wary least principles that were meant to endure be sacrificed to expediency. . . .

We appreciate the opportunity to express our views on this matter.

WRITTEN STATEMENT

of

JOHN L. WEINBERG
PRESIDENT
NATIONAL COUNCIL OF UNITED STATES MAGISTRATES

and

ARTHUR L. BURNETT
CHAIRMAN, COMMITTTEE ON LEGISLATION
NATIONAL COUNCIL OF UNITED STATES MAGISTRATES

and

JAMES T. TURNER
MEMBER, COMMITTEE ON LEGISLATION
NATIONAL COUNCIL OF UNITED STATES MAGISTRATES

submitted to the

SUBCOMMITTEE ON COURTS of the COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE

January 24, 1983

Washington, D.C.

HEARINGS

on

S.   : A BILL TO REORGANIZE THE BANKRUPTCY
COURT SYSTEM OF THE UNITED STATES

Our written statement is submitted based on the substance of the United States Judicial Conference's proposal to reorganize the Bankruptcy Court system, with related provisions dealing with retirement and salary of fixed-term judicial officers, as developed during the post-election session of the 97th Congress for its potential consideration.

The Judicial Conference's proposal contains numerous provisions to reorganize the country's bankruptcy adjudication and resolution system, including provisions to involve United States magistrates in major ways on a broad scale to assist (by references with consent of the parties or other appropriate delegation by a district judge) in adjudications which under current case law[1] are required to be made by Article III courts.

We illustrate in Part I below that the magistrates system in general and sitting magistrates in particular are and will remain capable of handling with dispatch and competence the increased responsibilities contemplated in the proposed bill.

The proposed bill also contains provisions pertaining to the salary and retirement of magistrates. These provisions, although currently occasioned by the pressing need for bankruptcy reorganization, are entirely independent of the bankruptcy provisions and deserve serious attention regardless of the plan adopted by the Congress to solve the bankruptcy crisis.

Our statement is to assure the Congress that magistrates are quite capable of assisting in the resolution of the bankruptcy crisis in the manner contemplated in the Judicial Conference bill. Our statement is further addressed to the bill's retirement and salary provisions.

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[1] See Northern Pipeline Construction Co. v. Marathon Pipe Line Co., _______ U.S. _______, 102 S.Ct. 2858, 50 U.S.L.W. 4892 (1982).

I. PROFILE OF MAGISTRATES

As a preliminary matter, we think it important to emphasize just who and what federal magistrates are. We feel that the caliber and achievements of sitting magistrates as well as the demonstrated likelihood of continued high caliber applicants for magistrate position vacancies is quite relevant to a bill which would enhance the duties and responsibilities of magistrates and which addresses the salary and retirement applicable to the position.

Magistrates are judicial officers of the United States District Courts.[2] Currently there are 223 full-time magistrates serving the federal trial courts. Although there are, in addition, 260 part-time magistrates, the provisions of the bill under consideration will, as a practical matter, affect primarily full-time magistrates.

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[2] The "two-year study" of the federal magistrates system by the United States Judicial Conference, which was mandated by Congress in the Federal Magistrate Act of 1979 (P.L. 96-82, October 10, 1979), entitled Report of the Judicial Conference of the United States to the Congress on the Federal Magistrates System, dated December 1981, contains a number of passages relevant to the legislation under consideration, including the following:

At 10, the Judicial Conference report states: "United States magistrates were established by the Congress as an integral part of the United States district courts. The jurisdiction which a magistrate exercises is that of the

(continued)

The federal magistrates system was created by a 1968 Act which was designed to provide judicial assistance for overburdened and backloged federal trial courts. Although this new system has been fully implemented for less than 12 years, 15 federal magistrates have become federal district judges and one has become a federal circuit judge, that being Judge Hatchett of the Eleventh Circuit Court of Appeals. Two have become state supreme court justices. One current full-time magistrate is the former dean of a law school and another is a former state supreme court justice. The Chairman of the Judicial Administration Division of the American Bar Association whose term ended in 1981 was a federal magistrate and has since been appointed by the President as a judge of the United States Claims Court.

(note 2 continued)

district court itself. . . ." At 15, the report continues: "The jurisdiction of magistrates to try civil cases extends to all cases pending in the district court."

At 42, the Judicial Conference said:

> The jurisdiction of magistrates flows exclusively from that of the district courts and is co-extensive, upon delegation, with that of the district courts. Judges and magistrates commonly work on the same cases, and the duties that magistrates perform dovetail with the work of the judges. . . .
>
> * * * Magistrates try civil cases that the judges would otherwise try in the absence of consent of the parties.* * * Magistrates are essentially a supplemental resource for each district court, and one of the primary benefits of the magistrates system as presently constituted is that it gives each court maximum flexibility to divide up the total work of the court in a sophisticated and efficient manner among the judges and magistrates to best meet local needs and changing conditions.

As part of the 1979 amendments to the Federal Magistrates Act (P.L. 96-82, Oct. 10, 1979), Congress expanded the trial jurisdiction of magistrates to include any and all civil cases, whether jury or non-jury and regardless of the subject matter or amount in controversy, and any and all non-felony criminal cases, so long as the parties consent to the magistrate's jurisdiction. Thus, as of October 1979, with consent of the parties, the available jurisdiction of magistrates in civil cases and non-felony criminal cases has been literally and precisely the same as that of United States district judges. This jurisdiction is routinely exercised by magistrates. Some of these trials involve commercial, contract and anti-trust matters similar to that involved in bankruptcy litigation. In addition, magistrates routinely handle a full range of other judicial duties, including every kind of pre-trial motion in civil and criminal cases, including felony cases.

As a result of the 1979 amendments to the Magistrates Act, a magistrate must have been for at least five years a member in good standing of the highest court of a state and must have been engaged in the active practice of law for a period of at least five years. In addition, magistrates must be selected by a public merit selection panel which includes both lawyers and lay persons. District judges may select as magistrates only those candidates screened and approved by such public merit selection panels.

Obviously, the Congress intended to create a system to provide federal district judges with qualified and capable judicial assistance. We submit that the program has been quite successful.[3]

II. RETIREMENT

We wholeheartedly support the retirement provisions of the bill (with a very minor exception addressed in our discussion of salary which follows [see note 7 below]). The bill, in essence, provides for full-time magistrates and other fixed-term judicial officers the retirement program currently applicable to territorial judges, i.e., an annuity equal to 100% of salary after 14 years of service and attainment of age 65. Currently, magistrates are subject to the same Civil Service program applicable to most non-judicial employees in federal service.

We feel that the Judicial Conference proposal recognizes that the typical magistrate leaves his or her law practice or other legal pursuit in mid-career to enter the judiciary and consequently never has the opportunity to accummulate the years of service which enhance one's Civil Service annuity.

Further, the full salary annuity is recognized as appropriate for the federal judiciary and will be a major factor in retaining and attracting the very highest caliber of practitioner.

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[3] Additional detail pertaining to backgrounds of sitting magistrates as of June 30, 1981, is set forth in the Report of the Judicial Conference of the United States to the Congress on the Federal Magistrates System, dated December 1981, at 29-30.

Highly qualified attorneys in private practice who may have earnings much in excess of anything available in the judiciary and who have the potential of securing an attractive annuity through private pension plans may nonetheless be attracted to the magistrates' ranks by the retirement system contained in the Judicial Conference proposal.

We refer to the Report of the Judicial Conference of the United States to the Congress on the Federal Magistrates System, dated December 1981, at 63, for an earlier statement of Judicial Conference position on retirement for magistrates.

III. SALARY

The proposed Bankruptcy Reorganization Act of 1983 contains a provision which would limit the salary of fixed-term judicial officers (magistrates, Claims Court judges and territorial judges) to a maximum of 85% of the salary of a district judge.

Currently, the payable salary of magistrates and bankruptcy judges is 87% of district judge salary ($63,600 compared to $73,100).

Currently, the payable salary of Claims Court judges is 89% of district judge salary ($65,200 compared to $73,100).

Consequently, enactment of legislation which would reduce the salary of these judges to 85% of district judge salary would result in both a reduction in percentage of district judge salary as well as a pay cut in terms of actual payable salary.

Further, by a legislative quirk resulting from the fact that the Bankruptcy Reform Act of 1978 (P.L. 95-598, Nov. 6, 1978) was not enacted into law until after October 1, 1978 (the beginning of fiscal year 1979), the payable salary of bankruptcy judges and magistrates is now less than United States Attorneys and public defenders and less than some clerks of court and probation officers. Enactment of the 85% maximum proposed in the Judicial Conference bill would exacerbate this unfortunate and unintended situation.

It was the obvious intent of Congress, which would have been achieved had the Bankruptcy Reform Act of 1978 been enacted before October 1, 1978,[4] to establish salary level of bankruptcy judges (to which magistrates' salaries are linked) at Executive Level IV which then had and which currently has a payable salary of 92% of district judge salary (currently $67,200 compared to $73,100).[5]

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[4] It was passed by the House of Representatives on September 28, 1978 and sent to the Senate on the same day.

[5] In enacting the Federal Magistrates Act of 1968 the Congress equated the salaries of magistrates to those of referees in bankruptcy. The Judicial Conference has consistently endorsed the principle that there should be parity in the salaries of magis-

(continued)

As recently as early December 1980, just prior to the Will[6] decision, the payable salary of magistrates was 89% of district judge salary ($48,500 compared to $54,500) and that of bankruptcy judges was 92% of district judge salary ($50,000 compared to $54,500).

The Quadrennial Commission, approximately two years ago, recommended a percentage of district judge salary higher than 85% ($85,000 for district judges and $75,000 for bankruptcy judges and magistrates) and the Judicial Conference, in its two-year study report submitted to Congress in December 1981, at 63, concluded that "[i]mplementation of these reasonable recommendations should be considered as a first step in restoring equity in compensation."

We wish to also refer you to the Report of the Judicial Conference of the United States to the Congress on the Federal Magistrates System, dated December 1981, at 62-63, for statement of the Judicial Conference position concerning salary of magistrates. The Conference there concluded: "In order to attract and retain the most capable attorneys as United States Magistrates it is essential to provide a salary commensurate with

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(note 5 continued)
trates and referees in bankruptcy or bankruptcy judges based on the responsibilities of the two offices.

Report of the Judicial Conference of the United States to the Congress on the Federal Magistrates System, dated December 1981, at 62.

[6] United States v. Will, 449 U.S. 200 (1980).

the experience and abilities needed for the job and consistent with the magnitude of responsibilities that must be exercised."

In order to correct the disparity which resulted from the timing of the enactment of the 1978 Bankruptcy Reform Act and to recognize the increased duties and responsibilities of magistrates and other fixed-term judicial officers since 1978, as well as the responsibilities contemplated in the proposed legislation, we ask that Congress select an appropriate percentage of the salary of district judges which, at the very least, will avoid any slippage of the salary percentage level below that previously attained.[7]

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[7] If our suggestion is adopted, the designation of 85% of district judge salary as a retirement annuity limit set forth in Sec. 236(a) "373(e)" of the bill should be changed to the percentage of district judge salary adopted by the Congress.

SUBMISSIONS RELATING TO CONSUMER CREDIT

TESTIMONY OF
THE AMERICAN BANKERS ASSOCIATION AND
THE CONSUMER BANKERS ASSOCIATION
BEFORE THE SUBCOMMITTEE ON COURTS,
COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE
HEARINGS ON MODIFICATIONS TO
THE BAKRUPTCY REFORM ACT OF 1978

Presented by
Paul G. Tongue

Mr. Chairman:

I am Paul G. Tongue, Senior Vice President of the Chase Manhattan Bank, N.A., and an active participant in a number of activities of both the American Bankers Association and The Consumer Bankers Association. The American Bankers Association's membership consists of more than 90% of the nation's full service banks including more than 12,000 community banks with deposits of $100 million or less. The Consumer Bankers Association has a membership of over 400 commercial banks of all sizes that are actively engaged in extending consumer credit, holding over 65% of all consumer credit outstandings held by commercial banks, more than $88 billion.

We greatly appreciate this opportunity to appear before the Subcommittee to discuss the important question of the treatment of the debtor's current and future earnings under the recently revised Bankruptcy Code. As both Associations testified before this Subcommittee earlier this year, the bankruptcy problem is one of the most critical issues now facing the retail banking industry. The direct impact of the new law, in conjunction with other factors, has produced substantial losses and the real potential for even greater exposure to future losses.

No single issue in the bankruptcy area is of greater concern and importance than the question of requiring the consumer to repay those debts -- or that portion of debt -- that are reasonable in relation to the consumer's ability to repay within the agreed time. This general concept, commonly referred to as "affordable debt", is critical because of the way in which consumer credit is extended in this country today and due to the need to provide a sound and equitable policy with respect to the shouldering of the costs created when consumers file under the Bankruptcy Code.

We are appearing here this morning in support of legislative relief that takes into account the findings presented earlier by Dr. Robert Johnson of Purdue University's Credit Research Center. We would like to discuss very briefly the bankruptcy context as it relates to the banking community, the demonstrated need for change in the way in which existing and potential earning power is treated under the bankruptcy code, and, finally, express our support for three amendments that we believe to be essential to a reasonable allocation of losses being generated by the bankruptcy system.

The Current Bankruptcy Context

Since the effective date of the 1978 Reform Act, bankruptcy filings have increased at an alarming rate. During the past calendar year bankruptcy filings were up 75%. From June 1980 to June 1981 filings were up 112%, suggesting an acceleration of filings. Perhaps of greatest concern, the figures on filings demonstrate that the increases cannot be directly correlated to current economic conditions as represented by the unemployment rate.

Several major banks have been able to quantify the impact of this massive increase in filing. Comparing 1979 with 1980, the first full year under the new law, one large Midwestern bank saw an increase in their dollar losses due to bankruptcy of 84.6%. In the case of that bank, in 1979 only 13.7% of its charge-offs were attributable to bankruptcy, while in 1980 that figure jumped to 25.8%. Other banks have seen bankruptcy losses during that period in connection with their bank card programs alone increase from $1.3 million to $3.3 million, 154% (a West Coast bank), from $1.1 million to $3.2 million, 191% (a New York bank) and from $1.45 million to $3 million, 110% (another West Coast Bank).

In the case of my own bank, losses on our VISA card program caused by bankruptcy jumped from $1.76 million in 1979 to over $5 million in 1980, an increase of 186%.

The impact of the law simply cannot be ignored. It has had a direct and adverse impact on bank profitability, which inevitably will affect credit costs for all consumers -- since consumers who pay their debts must pay the costs created by consumers who do not -- and the continued ability of banks to provide credit services. One study indicated that comparing 1979 with 1980, bank losses in the consumer lending area had gone up 40%. The study concluded that bankruptcy losses were a major contributing factor to that increase.*

In general, the losses do not stem from a few isolated examples of abuse, but rather from an increasing trend to use the bankruptcy mechanism to deal with what is essentially affordable consumer debt. In many cases, consumers who have sufficient income to meet their debts are finding that the burden of paying their debts can be more expediently cured by filing bankruptcy than by altering the lifestyle to which they have become accustomed.

Mr. Chairman, it is imperative that we emphasize that we are not here today to discuss a mere handful of isolated abuses under the new Act. While so-called "horror stories" may be helpful in providing clear evidence that the system permits abuses to occur, it is not that handful of cases which gives rise to our concerns. Rather, it is what appears to be an increasingly large percentage of filings by persons who have modest, but reasonable, incomes and who have debt structures that are not at all out-of-line with their incomes. It is this significant portion of new filings that is the source of most of our current losses and presents our largest exposure to future losses.

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* The study was performed by Keefe, Bruyette & Woods, Inc., a specialist in bank securities.

Immediate Bankruptcy Relief: Both Necessary And Appropriate

Before advancing specific suggestions for more equitable treatment of affordable debt, Mr. Chairman, we would like to address several arguments that have been advanced in suggesting that bankruptcy reform at this time is not appropriate. These arguments include the contentions that there has been too little time to analyze the effects of the new law, and that the credit industry, by overburdening the consumer with debt, is to blame for any surge in bankruptcy filing. As we will discuss, we earnestly believe that neither of these suggestions is valid and that relief from the current situation cannot reasonably be withheld on either of these grounds.

Impact Of The Act -- Currently And In The Future

There is an urgent need for immediate bankruptcy relief. That need, reflected by dramatic increases in both bankruptcy filings and in losses caused by bankruptcies, we believe has been fully documented. Moreover, the nature of the problem we are facing makes it certain that these problems will continue and even accelerate due to the inability of creditors to identify and therefore avoid potential bankrupts.

The current bankruptcy rules make potential bankrupts virtually "invisible" to creditors on the basis of the best credit evaluation systems that the credit industry has been able to devise. In a significant number of cases, literally the day before a consumer files a petition in bankruptcy, the consumer would be considered by the best credit scoring systems and judgmental evaluation approaches as being creditworthy and, indeed, entitled to additional credit.

To demonstrate the magnitude of this problem, one large West Coast bank studied a random sample of 320 bankruptcy cases. Based on a review of the bank's files, between 18% and 30% of those who filed would have been entitled to obtain additional credit the day before they filed. Thus, about 1 in 4 of those who filed, the day before they did so appeared to that bank's credit scoring system as good credit risks, with high credit ratings; consumers to whom that bank or any other creditor would have given more credit. How can the banking industry distinguish those credit applicants from the others who seek and want credit and will be able to repay it?

Because the new Act removed virtually all disincentives to filing, the cases we are experiencing now are not of the same type that we used to see under the old Bankruptcy Act. Those cases generally involved persons who were suffering the effects of unemployment or economic difficulties or health problems. Today, however, they are consumers who, by all criteria, were creditworthy when credit was extended and continue to be creditworthy despite the fact that they have a federal mechanism available for shedding their debts. As described earlier by Dr. Johnson, the recent study by the Credit Research Center revealed that in more than 78% of the households that filed for bankruptcy -- almost four in five -- there was a member who held a full-time job. This illustrates the changing nature of the cases being filed in the bankruptcy courts.

The long-term implications of this problem are clear. If the credit community were able to identify those who are in difficulty or who may be headed for difficulty, it would be a simple enough task to refuse to grant credit to them. If, however, as is now the case, those who have access to these proceedings are consumers whom we would identify as being legitimate, good credit risks immediately before filing, restrictions simply are not available. This means that the bankruptcy system has created the potential for persons who have affordable debt reflected by reasonable debt structures to take advantage of that system notwithstanding their economic ability to meet their obligations.

It is not responsive to suggest that such an inability is "the credit industry's problem;" it should develop better techniques. It is, of course, not "our" problem since, as a systematic matter, creditors who cannot identify consumers who are likely to use the bankruptcy process are unable to avoid extending credit to them. Those who have used that bankruptcy process -- and, thus, those who might use it -- do not have a profile, the common characteristics that might provide an alert to creditors in the course of their credit evaluation processes. Absent such information, potential bankrupts will remain invisible to potential creditors since literally no system can be devised to identify them.

The inevitable result, can only be one of two outcomes, neither of which is good. The first is that creditors will be forced to reduce credit availability generally -- in most cases starting by denying credit to the young and to lower income consumers. The second possible alternative is to regress from the current, highly efficient system which makes unsecured credit widely available, to the more cumbersome, expensive system under which all credit is secured by whatever collateral the consumer can provide. Neither result would be desirable either to the credit industry or to the consumers it serves.

In short, the new Act has caused substantial problems to date and since the credit system has no way of identifying potential bankrupts and thus excluding them from the credit market, the crisis is likely to intensify rather than moderate. Only by immediate remedial legislation -- admittedly not a cure-all but still a critical ingredient -- will it be possible to achieve a more reasonable balance between the rights of those who do pay their obligations and those who do not.

Immediate Legislative Action Is Appropriate

In light of the current crisis and the potential for even greater problems caused by the new Act's making potential bankrupts "invisible", we believe that Congressional action is needed now. We recognize that the new Act has not been the subject of a long period of judicial or administrative scrutiny. It seems certain that some of the current mechanical problems will be resolved as the judicial process shapes and responds to the new provisions. We strongly believe, however, that there are problem areas that arise either directly from the statute, or from judicial interpretations of the statute that seem likely to shape the law in this area absent further Congressional action.

We are limiting our comments this morning to the question of the appropriate treatment of debt that consumers can afford to repay in whole or in part. This is a matter that can only be changed by Congressional action. Limiting our comments to those areas, even though the statute has been in effect for only two years, we believe that the need for certain changes in this area has clearly been demonstrated and that the absence of an extensive period of actual experience should not stand as a barrier to remedial action. Indeed, as the losses described above demonstrate, immediate action is not only appropriate, it is essential.

In discussing both the need for, and the nature of, necessary changes, we understand fully that the 1978 amendments to the Bankruptcy Code under discussion today were the result of extensive efforts by many members of the Senate Judiciary Committee and others to attempt to arrive at reasoned compromises on difficult issues.

It says nothing negative about the exhaustive efforts of the past that all of us were unable to anticipate with precision how this new law would work in the real world. As the members of the Subcommittee are fully aware, the comprehensive Bankruptcy Reform Act of 1978 was the result of exhaustive efforts first by members of an independent Commission and then by members of both the Senate and the House. In fashioning the first comprehensive revision of the 1898 statute in forty years, it seems virtually inevitable that certain changes would require reevaluation once they had been tested in the real world. For example, it seems difficult to have anticipated fully the extent to which consumers would file low or no dividend plans under Chapter 13.

A rapid Congressional response to the unintended results of legislation is by no means unprecedented. In 1975, the Real Estate Settlement Procedures Act -- which established a series of timing and disclosure requirements in connection with residential real estate transactions -- became effective. Less than one year later, Congress, learning of the problems involved with it and the adverse unintended consequences it produced, substantially and significantly revised the original act. The amendments totally overhauling the statute were devised, adopted by both the House and Senate and became effective almost exactly one year after the effective date of the initial statute. The need for revaluation -- even on a relatively expeditious basis -- is neither inappropriate or unprecedented.

That seems particularly to be the case in view of the issues presented in the complex area of bankruptcy. The policy decisions reflected in the new Act involve deliberate and difficult line drawing among the interests of the various participants in credit transactions. It is not at all surprising that even the most carefully drawn response should be the subject of refinement once it has been tested in the practical legal and credit environments.

In drawing these lines, it is essential to point out that the traditional reference to favoring or harming "the creditor" is simply a shorthand reference to those who are actually paying the cost. Banks, as with literally all other creditors, virtually never assume the losses occasioned by bankruptcies. Rather, since banks operate as financial intermediaries, the costs generated by bankruptcies are merely passed on to other consumers in the form of higher prices for credit.

Thus, in a very real sense, the close policy judgments involved in the bankruptcy area must be viewed as weighing the interests of consumers who meet their credit obligations against the interests of those who cannot or do not meet their obligations. If for no other reason than to protect the vast majority of bill-paying consumers, the Act should not provide easy or routine or totally painless access to this federal governmental intervention which shifts the debts of the "non-payers" to the "payers." We are appearing before this Subcommittee in the sincere belief that the thoughtfully drawn lines contained in the current law, particularly as they relate to a total discharge of affordable debt, simply have not proved to be reasonable when applied in the real world.

Immediate Relief Should Not Be Delayed By Incorrect Assertions That Creditors Have "Overloaded" Consumers With Debt

Mr. Chairman, in considering the bankruptcy question, we feel that we must address forthrightly one recurring myth that some have suggested should somehow preclude the credit industry from seeking relief in this area. The myth is that creditors themselves are to blame for the bankruptcy problems since they have encouraged consumers to overload themselves by making more and more credit available, particularly in the past few years. It is this recent surge in credit, the argument goes, that has caused the increased bankruptcy filings in 1979 and 1980. The facts, however, clearly refute this suggestion.

The share of consumer income being devoted to pay consumer credit obligations was lower in 1980 than in any year since 1976. Moreover, the percentage of disposable personal income used for that purpose was actually lower in 1980 than it was in either 1971 or 1972. Viewed over the past twelve years -- that is, comparing 1969 and 1980 -- there is a difference of only 1.1% in the portion of disposable income allocated to these debts. In fact, since peaking during the end of the 1970's, the amount of disposable income being applied to consumer debt has decreased. These data clearly reveal that consumers are devoting less not more to payments of consumer debt.

In addition to an income statement analysis that demonstrates that consumers have not become overextended, a similar result is produced using a balance sheet approach. For example, at the end of 1979, consumers had increased their financial assets by $84 billion more than they increased their liabilities.* Quite clearly, on the basis of traditional balance sheet analysis, consumers are in a significantly better position than ever before.

The absence of overburdened consumers is also shown by looking at the total amount of consumer credit outstandings during the period in question. During 1979, consumer debt outstandings increased by 13%, a rate that simply matched the rate of inflation for that year. In 1980, however, there was an increase in consumer credit outstandings of only .45 of 1%, despite double-digit inflation and population increases that produced a larger number of potential credit consumers. Even these modest increases in the past few years are overstated due to changes in the composition of consumer credit. With an increased use of revolving credit has come a generation of "credit users" who in fact use revolving credit for convenience, paying off their balances each month. Historically, these would be cash and not credit transactions and so would not have been reflected in the credit aggregates that are reported.

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* See ABA Bulletin on Consumer Economics, First Quarter, 1980, analysis by Dr. Robert H. Johnson, Credit Research Center, Purdue University.

In short, Mr. Chairman, despite unsupported assertions to the contrary, the credit industry cannot be fairly accused of enticing consumers to overextend themselves, thereby giving rise to increased bankruptcy filings. Consumers are not too deeply in debt and consumer debt is well within reasonable limits permitting consumers to repay their obligations in accordance with their agreement.

Affordable Debt: A Credit Granting Standard And Its Bankruptcy Implications

As noted above, affordable debt refers to debt that is reasonable in relation to the consumer's ability to make payments over the term of the credit transaction. The affordable debt concept is of particular importance to consumer lenders because it forms the basis on which credit decisions are reached. Several decades ago, virtually all credit evaluation was based in large part on the assets owned by an individual and the creditor's ability to look to those assets if necessary in order to realize on its loan. During that era, consumers seeking credit would provide detailed financial statements, their assets and liabilities were carefully weighed, and any credit extended was secured, generally requiring the preparation of additional documents and the payment of various filing or recording fees.

As our country became more mobile, as lifestyles changed and consumers sought more credit that they could adapt to their needs, this somewhat cumbersome and expensive system of traditional secured installment credit gave way to less expensive, more flexible unsecured credit. This shift in consumer demand and expectation gave rise to the contemporary credit market in which the most dynamic force is unsecured credit.

Unlike traditional installment lending, which was based on assets, this new approach to providing credit services is based on the consumer borrower's current and future income. This almost complete change in the credit system, also caused changes in the evaluation process being used in connection with consumer credit. In the contemporary system, it is the consumer's income and debt structure that forms the principal criterion upon which credit decisions are made.

Because of that change, a bankruptcy process that looks only to a consumer's assets and disregards the consumer's ability to pay at least some of his or her debts out of future earnings, simply fails to recognize the dramatic changes that have taken place in the credit market. This produces a significant discrepancy between the underlying principles used by the industry in extending credit and the creditor's ability to recover in a bankruptcy situation.

Contrary to some suggestions, the validity of this approach to credit granting -- which provides low cost, flexible credit to consumers -- is not placed into question by the significant increase in bankruptcy filings experienced since the 1978 amendments to the Bankruptcy Code took effect. Indeed, as demonstrated by the figures provided by Dr. Johnson, even a significant portion of those who file bankruptcy have a substantial ability to repay their debts. The problem is not that the credit industry has been using incorrect measures of creditworthiness in meeting consumer demand. Rather, the problem has arisen due to the fact that consumers who have sought relief have been given a full discharge and not merely a discharge only to the extent that they cannot afford to pay their debts.

The answer to this problem requires legislative relief.

Bankruptcy Relief: A Necessary Triad Of Amendments To Chapters 7 And 13

In order to provide a more equitable approach both for persons facing financial adversity and those who are not --

but who must pay for the losses caused by the bankruptcy system -- the Associations would respectfully urge the Subcommittee to act favorably upon three critically needed amendments. The three interrelated amendments, a triad, if you will excuse a term being used a great deal these days in a somewhat different context, are essential to a reasonable solution of the current situation.

These amendments would permit consumers who do not have the ability to repay any of their debts to have a complete discharge of all of their debts. Those consumers who do have the ability to pay at least some of their debts, however, would be required to make payments to the extent of that ability. This result assures relief to the consumer debtor who is in economic trouble, while making certain that debts that are affordable are paid by the consumer who incurred them and not by other consumers who pay their debts.

First: Limit Access To Chapter 7 To Those Who Really Need It

The first amendment would limit access to Chapter 7 legislation bankruptcy proceedings to those who truly need this extreme form of relief. Consumers who because of illness, unemployment or other personal or financial problems simply cannot pay their debts and have no real prospect of being able to do more than meet their basic living expenses, would continue to file under Chapter 7. According to Dr. Johnson's data, this group includes over 50% of those now filing liquidation bankruptcies. These consumers would be unaffected by the change we are proposing.

Other debtors who are now filing under Chapter 7 and discharging debts that they could pay -- at least in part -- would be affected by the proposal. These debtors, who have the ability to repay non-mortgage debt, would be prevented from using Chapter 7. As Dr. Johnson has testified, this would mean under the proposed amendment that about $1.6 billion of debt a year, that consumers who are filing in bankruptcy could repay would not be discharged.

It bears repeating, that as we described above and as Dr. Johnson has testified, this means that $1.6 billion a year less -- relected in losses caused by defaulting debtors -- would be transferred to consumers who pay their debts. Both sound public policy and fundamental fairness dictate that this tremendous transfer of costs from non-payers -- who can pay -- to the payers, should be stopped.

In determining eligibility for Chapter 7, the court should decide whether the consumer has income, and is likely to continue to have income, from which he or she could pay a reasonable portion of non-mortgage debt after meeting basic living expenses. The court's decision would be based on information submitted by the debtor regarding his or her existing financial information, including both current and future income.

If the consumer is unable to pay a reasonable portion of his or her debts out of future income -- as would be the case in a majority of cases according to Dr. Johnson -- the consumer's petition in Chapter 7 would be approved. All debts would then be totally discharged.

If, however, the debtor can pay a reasonable portion of his or her debt out of future income -- after considering amounts needed for the debtor's support and that of his or her family -- the petition to discharge all debts would be dismissed. This produces nothing more than preventing a debtor who needs some relief from obtaining a complete release from all debts. These consumers, instead, would have the option to seek the measure of relief that is appropriate for their particular situations by filing under Chapter 13 of the Bankruptcy Code.

Second: Require A Reasonable Repayment Amount Under Chapter 13

By amending Chapter 7 in this way, the tremendous amount of debt that the debtor can repay but that is now being discharged, would not be automatically wiped out. That, however, is only the first of two essential steps that must be taken in order to prevent a shift of these costs to non-defaulting, paying consumers. The second critical step involves two amendments to Chapter 13.

The first of these two amendments would cure a major defect under the amended law that permits and may even encourage debtors to devote very little future income to repaying their creditors under Chapter 13. Under the new law, plans involving 0% dividends to unsecured creditors are not unusual and those with payments of 10% or less are plentiful.

In plans that involve no or very little return to the creditor, the bargain contemplated by the statutory pattern -- an exchange of an avoidance of the disruption caused by a liquidation bankruptcy for a reasonable dollar return to the debtor's creditors -- is not being met. Essentially, the absence of any standard in setting payment amounts produces a disguised Chapter 7 proceeding, except that the consumer is allowed to keep all of his or her assets and, in effect, continue without any change in lifestyle whatsoever.

In addition, Mr. Chairman, the absence of specific guidance has produced a disheartening array of percentage return plans for Chapter 13 creditors. Experience in different parts of the country illustrates the need for a more consistent standard. For example, in a recent six-month period in the Middle District of North Carolina, Greensboro Division, 415 Chapter 13 plans were confirmed. In 59.7% of the 36-month plans and 55.7% of the 60-month plans, unsecured creditors were to receive 100% payment on their claims. Moreover, 92% of the 36-month plans and 89.1% of the 60-month plans were to pay unsecured creditors at least 50%. Only .3 of 1% of all plans paid less than 10%.

Contrast this with the experience of the credit card operation of a major bank in the Midwest over a recent three-month period. Of the 263 Chapter 13 cases in which the proposed percentage of payout was known, the bank was to receive 100% in 37.3% of the cases, 50% or more in only 44% of the cases, and 10% or less in a startling 38.8% of the cases.

Why can debtors in North Carolina make significantly larger payments to creditors? This vast contrast cannot be explained on the basis of geography or demographics. The Midwest bank's figures are taken from a national card base not a local group. The difference can only be explained by the application of different standards by different judges.

In summary, a review of the actions of various courts -- presumably being presented with similar factual cases -- demonstrates that the shape of the plans being presented in these proceedings depends more upon where and before whom they are brought than upon a supposed national bankruptcy policy as reflected in the statute.

The necessary starting point in analyzing the "underpayment" problem is a recognition, as noted above, that the use of bankruptcy should be limited to those who actually need it. Unless some threshold test is to be applied in determining access to the bankruptcy process -- unlikely to provide relief since most courts undoubtedly would be reluctant to deny access to the courts to any consumer -- the barrier to use and potential abuse of the bankruptcy system must be an individual's reluctance to enter the system. This is not to say that a barrier should be erected that prevents consumers with significant economic problems from using this relief mechanism. Under the current provisions of Chapter 13, however, there are virtually no disincentives attached to this form of filing. Debts are erased, the consumer often pays little or nothing to unsecured creditors, and the debtor's property, furnishings and living quarters remain unchanged and undisturbed. In effect, the current law suggests absolutely no reason that consumers who would rather not pay their debts should not file a Chapter 13 proceeding.

In part, this has caused some to encourage consumers to file under Chapter 13 on the basis that they are simply debt consolidation proceedings without further significance. According to one tape recording that is available by calling a number provided in a West Coast newspaper advertisement, in response to a question "Is Chapter 13 a bankruptcy?", the answer given is,

> No. It is only a debt consolidation plan similar to a bank or finance company debt or consolidaton loan. The difference is that you do not have to pay 18% to 36% interest per year to consolidate your bills, the court charges only 3-1/3% per year.

It is that misperception of a Chapter 13 proceeding, as being nothing more than debt consolidation, that provides a powerful incentive for consumers to seek the protection of its provisions. Of course, it is not a traditional debt consolidation proceeding since they involve repaying the total amount of debt outstanding rather than a mere fraction. This is clearly not the case under many Chapter 13 plans today.

One very vivid demonstration of the impact of the new law was detailed by a bankruptcy judge in the Western District of Micnigan. In an opinion, the judge compared the repayments in Chapter 13 plans filed in his court between the period preceeding the adcption of the new Act and a month after the new Act took effect. Under the old law 88% of the Chapter XIII plans filed in that court were 100% plans; under the new law, 5% of the plans were 100% plans. Perhaps more strikingly under the oid law, only 2% of the cases filed involved payment schedules of 5% or less, while 53% of the cases fit into that category under the new law. This dramatic illustration should lay to rest any suggestions that it is just "business as usual" under the revised provisions of Chapter 13.

It should be noted that consumers who file these low payback plans in many cases do so even though they seem able to meet their debt burden. The result is that these consumers are in effect "using up" their ability to look to the federal law for protection in the event that they face real economic adversity. Those who are lulled into believing that a Chapter 13 proceeding is nothing more than a debt consolidation plan may find to their distress that when unemployment, economic or health problems, or other troublesome situations present themselves, they have no recourse to protection under Chapter 7 of the federal bankruptcy laws. Insofar as these very low payout plans hide the true character and significance of a Chapter 13 filing, consumers are unable to weigh and balance carefully the disruptions and economic and social costs involved in filing them. Once again, the signficance of providing some disincentive clearly weighs in favor of requiring a more realistic plan of those who wish to avail themselves of these protection provisions.

The problems of no or low payment plans simply are not addressed in a meaningful way by the Act. Under the existing provisions there is a reference to plans being proposed "in good faith" which according to some, but by no means all, courts relates to the extent to which payments are being made. In some jurisdictions, however, the courts have refused to apply the good faith test in measuring whether a consumer is making a fair and reasonable payment. Even where such a test is being applied, we would submit that "good faith" is simply too vague a concept to provide meaningful guidance to the courts, the creditor community or consumers themselves.

In order to promote uniformity and the implementation of a national policy, a more specific test should be devised. The Associations would submit that debtors should be required to pay as much as possible after the debtor has provided support for himself and his family.

Proposed plans that fail to meet these tests should not be afforded the safe harbor provided by Chapter 13. There should be a basic recognition that consumers who wish to enjoy the benefits of a Chapter 13 plan should have to make their creditors who finance those benefits considerably more whole than is now the case.

In short, the plans that have been produced under Chapter 13 have been repayment plans only in the most technical sense. So long as the federal law permits anyone to file at any time without losing property, rights, assets, or any other favorable aspects of their lifestyles, Chapter 13 will continue to provide a significant and unacceptable loophole in the bankruptcy system.

Third: Require That Payments Under Chapter 13 Be Made Over A Reasonable Period

The second amendment to Chapter 13 involves the related problem of the length of time over which the plan is paid out. The current law contemplates maximum payout periods of three years, except in extraordinary circumstances when the payout might extend for as long as five years. In fact, courts have been permitting considerably shorter payout periods without indentifying any signficant justification. As with the question of the payout amount, this issue, too, goes to the very nature of a Chapter 13 proceeding as an alternative bankruptcy choice.

Quite clearly, Chapter 13 involves a fundamental decision to permit consumers to look to their future earning power as a way of avoiding the more drastic consequences of a liquidation bankruptcy. Once again that trade-off is fair and equitable only if the trade-off involves a fair measure of return to the creditors involved. If the theory is that future income is to be used to meet the consumer's debt, it becomes of critical importance that the period during which that income is to be made available be reasonable.

A consumer should not be able to trade all outstanding debts for a very short-term allocation of earning power. Rather, Congress should clearly establish a reasonable period during which the plan is to take place. Given the current use of the three- to five-year period and the tendency in recent years to extend terms on various types of consumer debt, a reasonable solution would be to tie the amount of the dividend to unsecured creditors to the term of the plan. For example, we would argue that plans of under five years be permitted, but only where at least 70% of the claims of unsecured creditors are paid.

In any event, plans should be paid out over at least a three-year period with a provision that when appropriate to insure a reasonable return to all creditors, plans should be extended for an additional two years or a total term of five years. This would recognize both the debtor's interest in having some definite period during which to pay off the creditor, but at the same time, permit the court to look at the amount actually being received by the creditors and the period of time necessary in order to assure a reasonable return to the debtor's creditors.

The Three Amendments Are Inextricably Interrelated

It cannot be overemphasized that this triad of amendments -- one to Chapter 7 and two to Chapter 13 -- is completely interrelated. Since Chapter 7 and Chapter 13 present alternatives to consumers, to change one without the other simply unbalances the system. Insofar as there is a recognition that consumers should not be able to shed debts that they can afford to repay -- and, therefore a decision that these debtors should not be in Chapter 7 -- that policy decision must also be reflected by assuring that result when the debtor files under Chapter 13.

Moreover, only by modifying both of these alternative choices is it possible to make certain that consumers who need relief -- whether complete or partial -- are able to obtain relief without imposing inappropriate costs on other consumers of credit services. Considering either of these two chapters in isolation from the other creates the possibility that various fact situations might "fall in a crack" between the two chapters. Quite simply, a failure to recognize the close relationship between these two chapters may fail to assure reasonable relief tempered with fairness to consumers who pay their debts -- and must shoulder the losses caused by those who do not. Affordable debts now totalling $1.6 billion a year, should be paid by those who have incurred them. That sound public policy can be effectuated only by amending both Chapter 7 and Chapter 13 as described above.

Conclusion

Mr. Chairman, the American Bankers Association and The Consumer Bankers Association would like to join with all other segments of the creditor community in urging that Congress reassess certain portions of the Bankruptcy Reform Act of 1978 in light of the experience to date under that law. The most critical of these concerns involves the treatment of debt that filing debtors are able to repay.

Only through immediate Congressional action to amend Chapter 7 and Chapter 13, will it be possible to assure a more reasonable and responsible allocation of economic and social costs for all participants in the credit system.

Thank you for providing us with this opportunity to comment on the pressing need for bankruptcy reform.

THE
CONSUMER
BANKERS
ASSOCIATION

...an association for the
retail banking professional

January 24, 1983

The Honorable Robert Dole
Chairman, Subcommittee on Courts
Committee on the Judiciary
United States Senate
Washington, D.C. 20510

Dear Senator Dole:

The Consumer Bankers Association (CBA) has a membership of approximately 500 commercial banks of all sizes that are actively engaged in extending consumer credit. Combined, the members of CBA hold over 70 percent of all consumer credit outstanding with commercial banks. CBA was founded to provide a voice for the retail banking industry.

CBA has been a participant of the National Coalition for Bankruptcy Reform since its formation in 1981 and, during the 97th Congress, supported S. 2000 (The Bankruptcy Improvements Act of 1981) as reported by the Committee on the Judiciary on May 27, 1982. We welcome this opportunity to comment on the two most critical issues now facing the retail banking industry: the need for consumer bankruptcy reform, and the granting of Article III status to bankruptcy judges in order to reconstitute the court system as a result of the Supreme Court's ruling in Northern Pipeline Construction Co., v. Marathon Pipe Line Co. We endorse comprehensive legislation that would resolve both these problems. CBA recognizes that this Subcommittee has spent considerable time on consumer bankruptcy legislation and various proposals addressing the constitutionality of the bankruptcy judges' jurisdiction. Since the expiration of the stay of the Supreme Court's mandate in the Northern Pipeline case on December 24, 1982, the continued functioning of the bankruptcy courts is uncertain and has placed a pressing burden on Congress to legislate a solution at the earliest possible date. CBA believes that legislation providing both Article III status for bankruptcy judges and substantive amendments to the Bankruptcy Reform Act of 1978 will not only improve the court system, but will more fairly balance the positions of creditors and consumer debtors.

CBA has testified before this Subcommittee on two prior occasions to discuss the need for changes in the 1978 code. Attached is a copy of our October 29, 1981 testimony for the record, presented jointly with the American Bankers Association, which explains the impact of consumer bankruptcies on the retail banking industry.

The unprecedented growth in consumer bankruptcies is continuing. Though we recognize that this growth is due to several factors -- such as the economy, lawyer advertising and changing attitudes -- we believe that part of this problem can be solved by amending certain provisions

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of the 1978 code to eliminate abusive practices by consumer debtors. CBA supports any legislative proposals pending before this Subcommittee that would be modeled on the formerly introduced S. 2000 -- a bill that presented equitable solutions to the consumer bankruptcy problem. As the Senate Report on this bill stated:

> [W]hile the principal objection of the legislation is the elimination of those defects in the code which constitute unnecessary obstacles to the attempts of good faith creditors to recover upon lawful claims in bankruptcy, every effort has been made to ensure that the legitimate interests of debtors who are indisputably in need of bankruptcy relief remain protected.

The enactment of landmark bankruptcy reform in 1978 included a restructuring and modernization of the judicial system. After a decade of review, it was apparent that the referee system of administering the bankruptcy laws under the Bankruptcy Act of 1898 was simply outmoded. The expanded grant of jurisdiction to the bankruptcy judges under the 1978 code has resulted in a more efficient method of administering cases.

It has been asserted that a return to limited jurisdiction would not affect this new method of administration. We submit that this is an irresponsible conclusion. Limited jurisdiction will most certainly result in an increased burden on district court judges to handle matters that are not purely substantive bankruptcy issues. Furthermore, it would result in unnecessary proceedings in different courts for both creditors and debtors. The Article III solution to the constitutional uncertainty facing the bankruptcy court system is the only method of preserving the advantageous aspects of the adjudication method introduced under the 1978 code.

We are aware that the Subcommittee is preparing omnibus bankruptcy legislation addressing many other issues that do not affect our members. However, the area of repurchase agreements does concern us. Some of our members have had difficulty in enforcing their security interests when companies such as Lombard-Wall and Drysdale have filed for bankruptcy. We urge the Subcommittee to rectify this inequity by allowing the holder of the security interest in the underlying securities involved in a repurchase agreement to dispose of such securities in an expeditious manner.

Thank you for providing us with this opportunity to comment on the pressing need for consumer bankruptcy reform and an Article III bankruptcy court system.

Sincerely,

Drew V. Tidwell
General Counsel

THE
CONSUMER
BANKERS
ASSOCIATION

an association for the
retail banking professional

February 4, 1983

The Honorable Robert Dole
Chairman, Subcommittee on Courts
United States Senate
Washington, D.C. 20510

Dear Senator Dole:

The Consumer Bankers Association is submitting this statement for the record to urge the passage of an amendment to protect financial institutions that advance a seller funds on the basis of credit card charge slips and cannot ultimately collect the amounts from consumers because of the seller's bankruptcy and inability to deliver the goods or provide the service. The recent bankruptcy of Braniff and other concerns, which accept payment for goods or services in the form of charge slips before actually delivering the goods or providing the service, has emphasized the seriousness of the problem and the need for corrective legislation.

In a typical credit card transaction, (1) a consumer purchases property or services from a merchant, (2) the merchant takes the charge slip or similar document to a merchant bank or other financial institution and is advanced the face amount of the charge slip less a small discount, (3) the bank forwards the charge slip to the bank issuing the card, and (4) the card-issuing bank collects the amount of the charge slip from the consumer. In many instances the seller will fill out a charge slip when the consumer orders the property or service and before the underlying property or services are delivered or provided. In such cases the merchant usually will present the charge slip for immediate payment.

If the goods or services are not delivered or provided before the debtor files a bankruptcy petition, and are not delivered thereafter, the merchant bank faces a dilemma. The Fair Credit Billing Act provides, in essence, that the consumer need not pay for goods or services that are not delivered or provided. (16 U.S.C. §1666.) At the same time, however, the merchant bank cannot "charge back" the slips to the debtor.

The net effect of these transactions is to make the merchant bank an insurer of the merchant's obligations to the consumer in the event of the merchant's bankruptcy. In this connection, though Congress undoubtedly expected the Fair Credit Billing Act to encourage merchant banks to police merchants honoring their credit cards and to discourage shoddy and fly-by-night operators, it is doubtful that Congress sought to make such banks insurers of huge reputable national firms, such as Braniff, who encounter financial difficulties. Members of our organization have said that the small discount on the slips would have to be increased substantially if they were to assume such insurers' roles. Moreover, if

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merchant banks are treated as insurers, they may be tempted to withdraw credit card privileges of a financially unstable merchant if credit problems loom on the horizon. Since many merchants depend on credit cards for a substantial portion of their sales, such a withdrawal may result in a loss of customers just at the time a troubled business can least cope with such a loss. The Code should discourage such precipitous action to the greatest extent possible.

The amendment we have proposed achieves such a result by subrogating the merchant bank to the consumer's fifth priority position under section 507(a)(5) of the Code. Such subrogation is warranted by the important policy of the Fair Credit Billing Act to avoid placing the risk of the merchant's default upon the consumer, while at the same time trying to ameliorate the present situation where the merchant bank essentially acts as an insurer of the merchant's obligations. To the extent the purchase is for consumer goods or services, there is good reason to accord the merchant bank a fifth priority.

Under the old act, a person who paid priority claims generally was subrogated to the priority. See 3A Collier on Bankruptcy ¶¶64.205, 64.408 (14th ed. 1975). Although section 507(d) has the effect of reversing this rule, the change is not explained in either of the Committee Reports on the Code or the debate on the Code, nor is there any mention of such a provision in the Bankruptcy Commission's recommended statute. Since the Code became effective, at least one court of appeals has recognized the strong equities of the creditor, which discharged a priority wage claim, and granted subrogation. In re Missionary Baptist Foundation, Inc., 667 F.2d 1244 (5th Cir. 1982) (supermarket that cashed payroll checks that were subsequently dishonored subrogated to wage claims of employers). Moreover, the present provision seems directed toward professional sureties, who bond against the claims of a debtor and thereby must make a direct assessment of the credit risks involved, rather than merchant banks, which are thrust into such roles by the peculiar interaction of the Fair Credit Billing Act and the Bankruptcy Code.

In short, then, the amendment will both preserve the essential policy of the consumer priority and tend to encourage creditors to avoid precipitous termination of a merchant's ability to honor credit cards, while not undermining other provisions of the Code. We would urge your support to remedy this situation.

Sincerely,

Drew V. Tidwell
General Counsel

STATEMENT OF CONSUMERS UNION
ON RESTRICTING ELIGIBILITY CRITERIA
FOR CHAPTER 7 OF THE BANKRUPTCY REFORM ACT OF 1978

SUBMITTED BY ELLEN BROADMAN, COUNSEL FOR GOVERNMENT AFFAIRS

Mr. Chairman and members of the Committee, Consumers Union* submits the following comments on S. 2000 and regrets we were unable to testify at the January 24 hearings on this bill.

At the onset, we would like to state our philosophy on debt repayment. We believe borrowers should repay their debts absent any wrongdoing by the lender that justifies non-payment. However, we view bankruptcy as a necessary safety valve for individuals who cannot meet crushing debt burdens due to unemployment, illness, overextension of credit or other unfortunate circumstances. We are troubled by recent creditor-backed proposals, such as S. 2000 that could deny the bankruptcy remedy to many individuals who should be given a fresh start on life.

These provisions raise far reaching questions that should be carefully deliberated and decided separately from the constitutional questions raised by the Supreme Court decision on the stature of bankruptcy judges. Those constitutional questions should be addressed quickly so that bankruptcies may proceed in an orderly and efficient fashion. No similar reason exists for expedited action on the consumer bankruptcy questions. Congress therefore should give these issues the lengthy and careful consideration they deserve.

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*Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the State of New York to provide information, education, and counsel about consumer goods and services and the management of the family income. Consumers Union's income is derived solely from the sale of Consumer Reports, its other publications, and films. Expenses of occasional public service efforts may be met, in part, by nonrestrictive, noncommercial grants and fees. In addition to reports on Consumers Union's own product testing, Consumer Reports, with over 2.8 million circulation, regularly carries articles on health, product safety, marketplace economics, and legislative, judicial, and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

The Future Income Standard

Bankruptcy, which dates back to the formation of this country and is recognized in the U.S. Constitution .Art.1, sec.8, cl.4), serves the important rehabilitative purpose of enabling people who are overwhelmed with debt to start a new financial life. The tragic impact of financial troubles on families, personal health and emotional stability is well-known. There is a strong societal interest in alleviating this suffering so that these individuals can again lead wholesome constructive lives.

S. 2000 would deny bankruptcy relief to a borrower whose "total disposable income for a reasonable period after commencement of the case would be sufficient to repay a reasonable portion of debts." At first glance, this standard might appear quite reasonable. After all, why should people who might be able to pay some of their debts in the future be absolved of all their debt obligations? Why not, instead, require those borrowers to pay what they can and relieve them of liability for the rest?

However, closer scrutiny of this standard revels that it depends on unworkable, unfair criteria that could entangle unfortunate debtors in endless, degrading proceedings, prolong their futile struggle to meet unaffordable debt, and deny deserving individuals the fresh start now provided by law. Under S. 2000, disposable income is defined as "income that the debtor has, at the time of the commencement of the case, a reasonable expectation of receiving for the forseeable future." Use of terms such as "reasonable expectation" and "foreseeable future" would introduce uncertainties and inequities into the bankruptcy system. Will unemployed individuals who could find work within the "forseeable future," but who are drowning in unaffordable debt, be foreclosed from using bankruptcy to relieve themselves of these crushing debt burdens? How much income can be reasonably expected from these people? With unemployment rising and the job market shrinking, many individuals are being forced to accept lower paying or part-time jobs, furloughs or extended periods of unemployment. To determine an individual's future income, judges would have to consult economic soothsayers, mystics and crystal balls. The welfare of many citizens would hinge on the accuracy of their whimsical guesses.

The judicial proceedings applying the future income standards would be expensive and extensive. In order to argue that a debtor's future income will be high or low, variable or certain, and adequate or inadequate to meet a reasonable part of the debt, debtors and creditors would have to present enormous amounts of evidence on debtors' skills and possible career paths and our nation's expected business and economic developments. Counsel for debtors might demean their clients' ability to maintain jobs, advance in their careers, continue a stable family life, etc., in order to establish low future earnings and eligibility for bankruptcy. Individuals forced to undergo such degrading proceedings to qualify for bankruptcy might find any "fresh start" they ultimately secure to be quite stale.

Those who fail to establish their inadequacies and are thereby forced into a Chapter 13 proceeding could be drawn into five nightmarish years of court proceedings under S. 2000. After their initial Chapter 13 repayment plan was approved, they would be forced to return to the court to revise that plan whenever illness, job changes, divorce or other hardships affected their ability to repay. Courts could be flooded with petitions to modify Chapter 13 plans.

This bill actually should be entitled the Lawyers' Relief Act of 1983 since it would generate substantial amounts of legal work on bankruptcy eligibility and Chapter 13 revisions. Disparate judicial pronouncements on what future income can be anticipated and what is a reasonable living expense (see below) will undoubtedly engender litigation and further increase legal fees. Ultimately the American taxpayer would underwrite this unduly complex, inequitable and expensive judicial system.

Bankruptcy proceedings would be further complicated by the fact that individuals judges are likely to define the foreseeable future" quite differently. Some may view several years as foreseeable. Others may foresee a lifetime of employment.

After guessing an individual's income over the "foreseeable future," judges would then have to deduct from this income "expenditures that at the time of the commencement of the case are reasonably necessary to support the debtor and the debtor's dependents, and to operate any business of the debtor." This would force judges to engage in the difficult and rather paternalistic exercise of telling debtors how they may spend their money for personal expenses. Not only would the judges be required to intrude into these personal decisions, but they also would have to scrutinize the records of a debtor's business and second guess business judgments.

Finally, the judge would have to determine if a debtor's expected income, after deducting reasonable expenses, would be sufficient to pay off a reasonable portion of borrower's debts. Determining the amount of an inidividual's debts may be difficult with the advent of variable rate loans. Variable loans have interest rates tied to indexes that rise and fall. As interest rates fluctuate, the consumers' debt changes. Changes can be quite substantial. Take, for example, a variable mortgage with interest rates tied to a 6-month Treasury bill index. Consumers who in January 1978 purchased a $50,000 mortgage would have watched their mortgage interest rate jump from 9.15% to 17.39% by January 1981. Their monthly payments would have skyrocked from $408 to $722, a 77% increase. A recent national survey of savings and loan associations discovered that 48% of the associations offering these mortgages place no limit on interest rate fluctuations.[1/] Creditors are now beginning to offer variable rate credit cards and other variable consumer loans to protect themselves against interest rate changes. As variable loans replace fixed interest loans, determining a borrower's ability to pay these uncertain debts will become exceedingly difficult.

Bankruptcy Should Not Be Curtailed During These Risky Times

This proposed restriction on bankruptcy relief comes at an unfortunate time. Consumer credit has become quite risky. Creative and variable financing has transformed owning a home into an enormous gamble. The variable-rate phenomenon is spreading to non-mortgage credit as well. In the future, an individual could hold not only a variable mortgage, but also variable auto, home-improvement, education and credit-card loans. When interest rates suddenly rise, some individuals may desperately need the relief provided by bankruptcy.

Not only is credit becoming riskier, but creditors are now attempting to erase important state laws that protect consumers against unfair credit charges. Many states have abolished usury ceilings, for example. Creditors are now backing a federal legislation that would wipe out the remaining usury laws, even state laws used against loan sharks charging 50 or 60%.

By lifting usury ceilings, states invite creditors to charge unduly high, unaffordable interest rates. Unknowing

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[1/] American Mortgage Insurance Company, Survey of Savings & Loan Association' Adjustable Mortgages (September 10, 1981).

consumers in Arizona, which has erased usury limits, have been enticed to sign second mortgage agreements with interest rates over 50%. In other states, usury laws have been used to invalidate such unfair charges and relieve consumers of unaffordable debts. In the District of Columbia, for example, second mortgage scams involving interest rates as high as 80% have been ruptured using D.C.'s consumer usury law. A local consumer reporter, Ellen Kingsley, presented a five-part series describing these schemes on Channel 9's evening news.

In each case, an agent for a mortgage company preyed on an unsophisticated homeowner by offering a substantial loan with small monthly payments. In one case, an elderly women was offered a $13,500 Deed of Trust with a $135 monthly payment. She willingly accepted. She did not realize that $5,000 of that loan would be paid to the mortgage company for various fees so that she would only receive $8,500 in cash. Moreover, she was not told that at the end of one year, she would owe a balloon payment of $13,500. The monthly payments only covered interest. After adding all the fees and interest she paid, her effective interest rate was 80%.

This was not an isolated problem. After the news series ran, Ms. Kingsley reported that twenty-one viewers called her to report similar contracts they had been hoodwinked into signing. Some of these homeowners were able to prevent foreclosure proceedings and avoid losing their homes because of the D.C. usury statutes. If the creditor-backed usury preemption bill becomes law, consumers may be without any protection against these vicious practices and overwhelming debts. Borrowers may have to turn to bankruptcy to avoid onerous, unfair credit charges.

By attempting to deregulate consumer credit markets, legalize usurious interest rates, and extend extremely risky loans, creditors have created a more compelling need for retaining bankruptcy relief. For many, bankruptcy will be an essential escape from escalating, uncontrollable debt burdens.

The Proposal Could Increase Improvident Granting Of Credit

If S. 2000 were enacted and restricted bankruptcy relief, creditors would be more likely to promote credit aggressively to people who could not meet their payments. Overextension of credit could become a serious problem. Already, debtors most frequently cite "too much credit" as the major reason for seeking bankruptcy relief.[2/] Bankruptcy law should not be weakened to encourage irresponsible lending policies that burden individuals with endless debt.[3/] The current law better assures that creditors share responsibility for improvident lending.

The Increase In Bankruptcies Does Not Alone Justify Amending This Law So Soon After Its Enactment

Various creditor groups blame the recent dramatic rise in bankruptcies on the October 1979 changes in the bankruptcy law. They argue that the bankruptcy increases justify restricting its availability. However, since bankruptcy eligibility criteria were not relaxed by the 1979 amendments, the rise in bankruptcies does not justify the extreme proposed revisions in these criteria.

Besides which, there are many factors other than the 1979 revisions in the law that have affected bankruptcy rates. Since October, 1979, interest rates have vacillated wildly and remained at unprecedented peaks, unemployment has reached extraordinary highs, the ratio of consumer debt to income has been substantial, and the economy has been quite depressed.

[2/] Brimmer, A., Public Policy and the Economic Implications of Personal Bankruptcies, Statement before the Senate Subcommittee on Courts (April 3, 1981) at 16 (57.5 percent surveyed cited using too much credit as a major factor in their decision to file for bankruptcy).

[3/] Countryman, Vern, Improvident Credit Extension: A New Legal Concept Aborning? 27 Me. L.R. (1975)

The correlation between bankruptcy rates and both unemployment and interest rates has been well documented.[4]

Marital difficulties, medical expenses and age also have been shown to correlate with bankruptcy rates.[5] In recent years, divorce rates and medical costs have risen considerably. Also, members of the post-war baby boom have entered and greatly expanded the 25 to 35 age group, which most frequently files for bankruptcy. Bankruptcies may have increased because consumers have been made more aware of their rights through attorney advertising, which was found to be constitutionally protected in 1978. To the extent that needy individuals are exercising their rights in greater numbers, this increase is desirable.

The dramatic rise in business bankruptcies also has had an impact. When businesses fail, owners who personally guaranteed business loans often are forced into bankruptcy themselves, causing personal bankruptcy rates to rise. The rise in personal bankruptcies also may be tied to the remarkable rise in consumer credit, especially to the rise in the debt to personal income ratio, in recent years.

Thus, factors other than the change in the law clearly have played a significant role in the increase in personal bankruptcies. Before making hasty changes, we should acquire additional experience with the new law and a better understanding of the reasons for the increasing bankruptcies. Bankruptcy rates under favorable economic conditions also should be evaluated before acting to severely limit debtor remedies.

Reaffirmation of Debts After Bankrutpcy

Bankruptcy erases debts to enable individuals with serious financial problems to have a fresh start on life. Nonetheless, creditors have used a variety of ploys to pressure debtors into reaffirming debts that were released through bankruptcy. Such reaffirmations defeat the Act's objectives.

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[4] Brimmer, *supra* n. 2 at 16.

[5] Id. at 17.

The Commission on Bankruptcy Laws, prior to the enactment of the current law, found reaffirmations to be a serious problem:

> Substantial evidence of the use of reaffirmations to nullify discharges has come to the Commission's attention. To the extent reaffirmations are enforceable, the "fresh start" goal of the discharge provisions is frustrated. Reaffirmations are often obtained by improper methods or result from the desire of the discharged debtor to obtain additional credit or continue to own property securing a discharged debt.

The Commission viewed this problem as so significant that it recommended that all "reaffirmations be made unenforceable."

In 1978, the bankruptcy act was amended to invalidate reaffirmations in general unless they were reviewed by a court and the court found the reaffirmation to be in the debtor's best interest and not to impose undue hardships. CU believes these important provisions should be retained.

Under S. 2000 reaffirmation would not have to be approved by the Court. Nor would reaffirmations have to be in the debtors' best interest. In fact, reaffirmations that imposed undue hardships on debtors would be perfectly legal.

Reaffirmed debts would be enforceable if included in a contract with a statutorily required disclosure. That disclosure would have to inform debtors that they could rescind the agreement prior to discharge or within 60 days after the agreement is entered into, whichever occurs later, by giving written notice of the rescission to the creditor. S. 2000 would encourage creditors to return to the days of scheming and high pressure tactics to extract reaffirmations that are deleterious to debtors and that nullify the bankruptcy altogether.

Conclusion

Consumers Union appreciates your attention to our concerns about S. 2000. We have addressed three of the bills' provisions, but also strongly oppose many of the others. We urge you not to rashly adopt these ill-advised creditor-backed changes to the relatively new bankruptcy law on the basis of isolated horror stories and ambiguous statistics. These difficult economic times, and rising bankruptcy rates, should not be used as an excuse for imposing even greater financial hardships on individuals who are drowning in unaffordable debt.

THE ONLY VOLUNTARY ASSOCIATION
SERVING THE ENTIRE WORLD OF CONSUMER CREDIT

International Consumer Credit Association

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January 24, 1983

Hon. Robert J. Dole, Chairman
Subcommittee on Courts, SD 212 (2204)
Senate Judiciary Committee
United States Senate
Washington, DC 20510

Re: Hearings on Amendment of Bankruptcy Act

Dear Senator Dole:

Today our nation stands in the midst of the worst economic crisis that the American people have had to face since the Great Depression. During 1982, businesses have taken bankruptcy in record numbers. One out of every ten full-time workers in unemployed. And a recovery that a year ago seemed just beyond the horizon is still there.

Today, January 24, your Subcommittee on the Courts of the Senate Judiciary Committee is conducting a hearing on the need for amendment of the Bankruptcy Act of 1978 and all matters related thereto. As the result of a decision of the U.S. Supreme Court effective December 24, 1982, the bankruptcy court system is believed to be in crisis. If it is, the nation's economic crisis is a more important one, which should be foremost in the minds of members of Congress as they deal with amendment of the Bankruptcy Reform Act of 1978. Further, if there is a crisis in the bankruptcy judicial system, there is an equal crisis in the consumer credit industry arising from record consumer bankruptcy filings, and it should be recognized that a strong and healthy consumer credit industry must be preserved to sustain economic growth when it resumes.

The ICCA, formerly known as the National Retail Credit Association, is a trade association for companies, organizations and individuals that engage in consumer credit granting, collection and reporting. The ICCA has about 22,500 members, most of whom are smaller consumer credit granters of all types. Its membership also includes home mortgage lenders, collection agencies and credit bureaus. Consequently, it takes a position only on legislation involving major issues that affect the consumer credit industry as a whole. Being a part of the National Coalition for Bankruptcy reform, the ICCA supported both S. 2000 and H.R. 4786 of the 97th Congress because ICCA members of all classes have been adversely affected by the flood of bankruptcies which has occurred since the Bankruptcy Reform Act of 1978 became effective on October 1, 1979.

Among other reasons, the ICCA has a particular one for supporting a successor bill to S. 2000. It will serve to restore Chapter 13 of the Bankruptcy Code more closely to the original intentions and purposes of Congress expressed in 1938, when the Chandler Amendment, originally proposed in 1935 by the ICCA (then NRCA), was enacted.

Chapter 13 was intended to provide a means whereby debtors could elect to rehabilitate themselves by paying off both their secured and unsecured creditors under court protection. As it has been amended through the Bankruptcy Reform Act of 1978, it is often being used by debtors as a means of keeping possession of property subject to security interests while paying less than is due to the creditors holding those security interests and as little as possible to the debtor's unsecured creditors.

Traditionally, there have been social and economic stigmas against consumers who have filed for straight bankruptcy under Chapter 7, regardless of the causes of their financial problems. While the social stigma has diminished substantially in recent decades, the economic stigma has remained as strong as ever. Very few consumer credit granters or home mortgage lenders will knowingly extend credit to a consumer who has filed for relief under Chapter 7 of the Bankruptcy Code. Chapter 13 was conceived by the ICCA to give financially-distressed debtors an alternative--to give those with both the means and the will not only a "fresh start," but also an opportunity to rehabilitate themselves with those creditors with whom they were doing business, to save their self-respect and to meet their moral obligations to their creditors.

When the Bankruptcy Reform Act of 1978 was before Congress, the International Consumer Credit Association and others in the consumer credit industry did not oppose its enactment. The need for judicial reform was beyond question. And soaring bankruptcy losses were not anticipated, especially among unsecured creditors. The losses sustained by consumer credit granters, even in the years when surges in bankruptcy filings resulted from recessions, had been sustainable, and relief for distressed debtors was a tradition in this nation. Further, both Congress and the consumer credit industry were unaware that social and economic changes were taking place in the nation that would soon aggravate the factors that often trigger consumer bankruptcies, such as rampant inflation and lawyer advertising of cheap divorce and bankruptcy services, which are closely related.

Since the Bankruptcy Reform Act became effective, consumer bankruptcy filings have climbed to an almost unbelievable new record. Successively mounting losses to creditors from bankruptcy of consumers from October of 1979 to date have brought about a variety of response from the consumer credit industry. Creditors are withdrawing from credit markets where bankruptcy losses are greatest. Availability of consumer credit is being curtailed, especially to those who need it most. Jobs are being lost. And record high interest rates are in part reflecting the fact that the cost of bankruptcy losses is being passed on to all who use consumer credit.

Since the Bankruptcy Act of 1978 became effective in October of 1979, the losses that consumer credit granters of all kinds have sustained have been double the losses during the worst year under the old Bankruptcy Code. This is an average for both big and little creditors alike, but the ability of smaller creditors to sustain such losses is not as great. Allegations that S. 2000 was a "small loan company" bill were false. Consumer credit granters of all types, large and small, supported that bill.

Now a united consumer credit industry composed of consumer credit granters of all sizes and all kinds is asking Congress for relief through amendment of the Bankruptcy Reform Act of 1979 without further delay. However, prompt and proper relief may be impaired by certain myths and misunderstandings that exist regarding the old Bankruptcy Code, the Bankruptcy Reform Act of 1978, the current surge in personal bankruptcy filings and S. 2000. The ICCA presents the following views and recommendations to aid in eliminating these myths and misunderstandings:

1. The old Code would not have prevented the surge in personal bankruptcy filings since October 1, 1979, but it would have been a substantially-greater restraining force.

Personal and family economic circumstances have always been the underlying reason that consumers file bankruptcy petitions. Such adverse economic circumstances now, as in the past, usually are triggered by loss of income, loss of employment, serious injury or illness, divorce or some other calamity. These factors have been aggravated in recent years, particularly by the worst recession since World War II. But today there are also the new triggering factors of inflation and bankruptcy lawyer advertising. However, translating individual and family indebtedness and individual and family income into constant dollars for comparative purposes, it is evident that less-burdened debtors in larger numbers are seeking relief now under the Bankruptcy Reform Act of 1978 than under the old Code. (Attached to this letter is data in constant dollars from 1947 through 1981 to prove this.)

The reason for record consumer filings is sufficiently clear. The old Code was a stronger restraining force. Exemptions were far less liberal under Chapter 7, and greater self-discipline was necessary for a wage-earner's plan under Chapter 13. Filing was more difficult and was about twice as costly. Spouses were obligated to file separately. Bankruptcy lawyer advertising was nearly non-existent and was less enticing.

Since the Bankruptcy Reform Act of 1978 was enacted, the nation has encountered two economic recessions and a massive increase in divorces. The surge in bankruptcy filings in 1979 through 1982 reflects these factors, but less surge would have occurred under the old Code. But since 1978 a new phenomena is being observed. Consumers who have suffered no calamity and who are not seriously delinquent in paying their debts (or sometimes even delinquent at all) are seeking relief. Debtors whose profiles are no different than others who are going along paying as agreed are filing bankruptcy petitions in large numbers, when they would not have under the restraining influences of the old Code.

2. While the Bankruptcy Reform Act of 1978 is not the sole cause of the continuing surge in personal bankruptcy filings, it is the major contributing factor.

Neither the old Code nor the Bankruptcy Reform Act of 1978 set any real standard for eligibility for bankruptcy. The old Code had a potential for abuse by persons who were not overburdened to file, but it was reflected only by occasional "spite filings" where a consumer filed to escape payment to some creditor where hard feelings were involved. Now that potential is being realized because the liberal provisions of the new Code with respect to exempt property, retention of property subject to security interests which is not exempt and severe restrictions on the reaffirmation of debts are encouraging consumers to file petitions when they would not have under the old Code. Today, many consumers are filing under the mere "pangs of inflation"--persons who have suffered no economic calamity and who have no real need for relief when compared to others in like economic circumstances.

The Bankruptcy Reform Act of 1978 is enticing a disturbingly large number of debtors into having their debts voided, often without the economic penalty of loss of assets being coupled to the economic benefit of voidance of their debts.

3. Neither S. 2000 nor H.R. 4786 demonstrated that those who were responsible for framing and enacting the new Code acted shortsightedly or with poor legislative judgment.

Personal bankruptcy occurs among consumers at all economic levels. Consumer credit generally is not asset-oriented, since its foundation is the promise to pay out of future income. Personal bankruptcy is not triggered by an excess of liabilities over assets, but rather a repayment burden that is out of proportion to discretionary income and disposable personal income. Congress was well aware of these facts, in framing and enacting the Bankruptcy Reform Act of 1978. Its purpose was to continue to afford relief to distressed debtors.

Under the old code, the typical petitioner was a heavily-burdened debtor seeking to escape the pressure of creditors who were threatening either seizure of property, or garnishment. With few exceptions, these were persons deserving of relief. They will still get it if legislation based on S. 2000 is enacted.

But under the new Code, relief is often being provided to debtors who are not under that kind of pressure from their creditors, and even a goodly number who are not even delinquent in their repayment. Unlike the old Code, the new one is being abused, and it is occurring with frequency.

This abuse seems to be frequent, too, under Chapter 13 because its provisions have been altered. Instead of serving its original purpose of providing relief so that a debtor could pay off his creditors in full under the protection of the court to achieve at least moral rehabilitation with respect to the obligation of contracts, the new Code is encouraging consumers to elect Chapter 13 to be able to keep non-exempt property at the least possible cost of repayment to their creditors.

4. The current surge in personal bankruptcy filings began before the 1980 and present recessions and is atypical of rises in filings that resulted from earlier downturns in the national economy.

Recessions bring economic calamity to consumers that results in a rise in bankruptcy filings. Historically, the delinquency rates of creditors rise sharply as a downturn develops, and bankruptcy filings rise to reach a peak as the recovery sets in. Economic distress arises in the downturn, but pressure from creditors does not develop until consumers' incomes are resumed or increased to prior levels. So the worst is yet to come.

The present, continuing surge in bankruptcy filings was not preceded by and is not being accompanied by a corresponding rise in delinquent debts. At present, consumer credit delinquencies are below usual recession ranges, and it is only in the last year that home mortgage delinquencies have reached such levels. Consequently, factors other than economic calamity are substantially responsible for the current bankruptcy surge. Among them are inflation, the rising rate of divorce, the enticement of bankruptcy lawyer advertising and the new Code itself, which should be regarded as the most important and controllable of the group.

Obviously, the time is at hand for the development of a new philosophy for providing relief for debtors through bankruptcy. Potential and actual abuse of the existing law makes it imperative to justify the rationale of providing "bankruptcy on demand" and relief through the "over-kill" of voiding all of the debts of consumers. That kind of relief should be reserved only for the deserving.

5. Neither over-use of credit in the aggregate by consumers nor over-extension of credit by the industry is a significant factor in the current surge in filings.

Since 1976, a massive change has taken place in the manner in which consumers spend their incomes. During this period, the necessities of life (especially food, medical care, transportation and housing) have been accounting for an increasingly larger share of disposable personal income each year. Consequently, discretionary income, which provides for the repayment of consumer credit, has been diminishing. This decline has been responsible for both restrained use of consumer credit and some of the surge in bankruptcy filings. Increases and declines in consumer discretionary income are the critical factors that affect aggregate consumer willingness to use credit and ability to repay.

On a current dollar basis, during 1977 through 1981, consumer instalment credit outstanding rose sharply due to inflation. Because of the credit controls and subsequent recession in 1980, followed by the present recession, outstandings declined on a current dollar basis. During 1981 and 1982, expansion, if any, has been at a very slow rate.

Under the pressure of inflation, if unit sales of goods and services remain constant, consumer instalment credit outstandings grow, unless less credit is used. From the recovery in 1976 to the end of 1981 on a current dollar basis, growth in consumer instalment credit outstanding has not kept pace with inflation, so growth in outstandings on a constant dollar basis has been less than expected and even negative over the last two years. (See proof in the Federal Reserve Board constant dollar data attached.)

Since the beginning of 1979, voluntary credit allocation by the industry and rising interest rates have served as a deterrent to both the extension and use of consumer credit. Restraints on both the supply and demand for credit have served to keep delinquencies at close to normal rates.

6. S. 2000 did not propose to make Chapter 13 involuntary.

Filing for relief under Chapter 13 traditionally has been voluntary and should remain so. Allegations that S. 2000 proposed to force consumers into Chapter 13 by denial of relief under Chapter 7 are erroneous. Further, Chapter 7 relief would still be available, as before, for those filing under Chapter 13.

If the reforms proposed through H.R. 4786 work as anticipated, those debtors who meet the standard for relief under Chapter 7 will receive it, although many who could meet the standard will opt for relief under Chapter 13. Those who file for Chapter 7 and are denied relief under it will have the alternative of settling their debts with their creditors outside the protection of the bankruptcy courts, or within it through Chapter 13. Election of Chapter 13 will continue to be voluntary, because of the advantages it offers to debtors. Adoption of a standard for relief under Chapter 7 will serve to prevent abuse of the Code and will provide greater equity for creditors, without hardship to debtors deserving relief.

7. S. 2000 can be improved by revision of Chapter 13 so that the rehabilitation of consumers who utilize it to pay off their creditors will be more complete and rewarding.

Chapter 13 as originally proposed by the ICCA and as incorporated into the old Code had a disadvantage to debtors that has been perpetuated and made more significant through the Bankruptcy Reform Act of 1978.

Under the old Code, if a debtor electing Chapter 13 successfully completed his plan and paid off his creditors in full, that person thereafter was still a bankrupt in the eyes of the law and in the view of some creditors with whom the debtor had not previously done business. Consequently, rehabilitation was incomplete. For this reason, many attorneys handling personal bankruptcy cases were reluctant or unwilling to recommend Chapter 13 to their clients.

While Chapter 13 served with success in rehabilitating debtors with creditors with whom they had been doing business, this purpose has been largely frustrated through revisions made through the Bankruptcy Reform Act of 1978. Proposal by the debtor of a plan to pay off creditors in full is no longer required. Consequently, the full stigma of Chapter 7 is now being extended to debtors who elect Chapter 13.

Therefore, the ICCA urges reinstatement of the original purposes of Chapter 13 and its revision to make it more successful. This would result if the chapter were amended so that, if a debtor would successfully complete a plan in which creditors are paid in full, the debtor would be entitled to have his bankruptcy expunged from the records, so that under the law and in the eyes of society that person would be neither legally nor morally a bankrupt. This proposal, if adopted, would encourage fuller use of Chapter 13 because debtors would be offered the opportunity for true and more complete rehabilitation. Further, the proposal is neither in conflict with nor inconsistent with S. 2000 as originally drafted.

According to the Administrative Office of the U.S. Courts, a total of 452,732 consumers filed individual or joint petitions for personal bankruptcy during fiscal 1981. That number is more than double the record 224,354 persons who took bankruptcy during fiscal 1975, when the nation was emerging from the worst recession since World War II. The record for fiscal 1982 was about the same as for 1981. Therefore, it is no wonder that consumer credit granters of every size and type are disturbed about recent levels of consumer bankruptcies and attribute it primarily to the Bankruptcy Reform Act of 1978.

In 1978, Congress sought to enact legislation that would produce two major reforms in a law that had only one since 1898. First, it sought to achieve judicial reform that would improve the system. Second, it endeavored to balance the rights of borrowers and lenders. Neither effort has been as successful as everyone hoped. Mistakes were made, but an even greater mistake would be to act now to cure the problem of judicial jurisdiction without at the same time tightening up consumer bankruptcy.

Federal data shows that there were about two bankruptcy filings per 1,000 U.S. households during 1978 under the old Code, whereas that rate jumped to about 5.5 per 1,000 households in fiscal 1981, the last year for which full data is available. The jump began immediately with effectiveness of the new Code and continued before the present recession set in. Before the end of 1978, it became evident to consumer credit granters of all kinds that the new law was unfair to creditors. That is why the National Coalition for Bankruptcy Reform was organized, and why the International Consumer Credit Association joined it and continues to support this industry-wide effort. For the last two years, consumer bankruptcy and the staggering losses arising from it have been the chief concern of ICCA members at meetings and conferences.

It is impossible to calculate the bankruptcy losses of the consumer credit industry for fiscal 1981, 1982 and the present year, but the ICCA believes that an estimate of $6 billion per year is conservative, because bankruptcies generate not only bad debt losses but also administrative and legal expenses. In the not-too-distant past, $6 billion was in excess of total industry bad debt losses.

Everyone ought to recognize that legislation to amend the Bankruptcy Reform Act of 1978 did not move in the 97th Congress because of a divergence of views of legislators, the judiciary, academicians and the consumer credit industry. The ICCA believes that, in the interest of moving the nation ahead economically, all these parties should follow the lead of the Social Security Commission, which came together and reasoned out a package that no one commisioner liked, but which all recognized as necessary. Similar action should be applied to the bankruptcy dilemma. There is no reason that all of the parties cannot agree to a workable bill that will help everyone.

Sincerely yours,

William J. Henderson

WILLIAM J. HENDERSON, President

WJH:jm
Enclosure

CONSUMER INSTALMENT CREDIT

OUTSTANDINGS AT YEAR END

1947 Through 1981 in Constant Dollars

(Source: Federal Reserve Board. *All in millions of dollars.)

Prior: Not Available
1947: $12,989.01
1948: $16,868.79
1949: $21,921.14
1950: $26,637.46
1951: $26,416.94
1952: $32,647.53
1953: $38,255.52
1954: $39,136.79
1955: $46,856.04
1956: $49,956.32
1957: $51,817.25

1958: $ 50,920.75
1959: $ 57,838.26
1960: $ 62,225.14
1961: $ 63,137.18
1962: $ 68,725.06
1963: $ 76,798.12
1964: $ 86,052.44
1965: $ 94,962.69
1966: $ 98,803.19
1967: $101,030.37
1968: $106,729.87
1969: $112,401.06

1970: $112,144.50
1971: $121,038.87
1972: $131,464.00
1973: $142,693.62
1974: $136,366.19
1975: $134,371.87
1976: $143,991.81
1977: $162,026.75
1978: $178,386.62
1979: $185,728.62
1980: $169,535.94
1981: $167,273.00

* Computed from 1970 through 1981 using Commerce Department Personal Expenditures Deflators.

STATEMENT OF THE LEADERSHIP CONFERENCE ON CIVIL RIGHTS REGARDING CHANGES IN THE BANKRUPTCY LAW

SUBMITTED BY RALPH G. NEAS, EXECUTIVE DIRECTOR

The Leadership Conference on Civil Rights, a coalition of 165 national organizations, has serious reservations about changes in the bankruptcy laws proposed by the credit industry. We believe these changes would weigh most heavily on the working poor and low-income people, thus placing a disproportionate burden on minorities and households headed by women.

In trying to make their case for change, creditors use the example of a professional with a good, steady income who goes on a buying spree and then files for bankruptcy, leaving creditors empty-handed while the debtor is free to enjoy his "ill-gotten" goods. This, of course, is not the typical bankrupt. Studies show that the vast majority of bankruptcies are filed by blue-collar workers, between 25 and 35 years of age, who have suffered unforeseen financial reverses such as loss of job, uninsured illness, or divorce. A detailed case study of bankruptcies in Connecticut done by Professor Phillip Shuchman of the Rutgers University School of Law showed that the mean annual income for those people filing for bankruptcy in 1979 was $11,744, more than $100 a month below the Bureau of Labor Statistics' lower-living budget for the same period. Most of those in the study had unstable incomes: they were employed in marginal jobs, at an hourly wage without steady employment.

In testimony before the House Subcommittee on Monopolies and Commercial Law on March 23, 1982, Christopher Guiliana of the United Auto Workers Legal Services Plan in Newark, New Jersey, presented a similar profile of the typical bankrupt his organization served. Most were hourly workers who had been laid off or had had their wages frozen and had lost other benefits as the auto industry suffered a depression. Most were one-wage-earner families; so there was no second income to supplement unemployment benefits to support families and pay debts incurred before the layoffs.

The vast majority of people filing for bankruptcy relief under Chapter 7 are not slick operators trying to fleece the credit industry. Instead, they are tired, frightened people, unable to make ends meet in an economy gone sour through no fault of their own. Most often they seek bankruptcy relief only when threatened with inescapable economic disaster -- for example, the garnishment of the wages of a working mother who is the sole support of several children. When faced with mountainous debts taken on in good times, plus frequent layoffs, a shortened work week, and the threat of future unemployment, most debtors have no place to turn but to the bankruptcy court to discharge their debts and obtain a fresh start.

However, at a time of the highest unemployment since the Depression, the credit lobby is attempting to block this avenue of relief for debtors overburdened at least partly because of the easy credit extended to them. Under the creditors' proposals, debtors would be forced to prove in court that they were unable to pay a "reasonable portion of their debts" out of "anticipated future income" over a three-to five-year period before obtaining Chapter 7 relief -- in effect foreclosing Chapter 7 to any person with any anticipation of future income, no matter what his economic circumstances were.

Identical attempts to undermine the fresh start principle have been made in the past. Each time Congress has quickly rejected such changes in bankruptcy law. In fact, when a proposal to suspend bankruptcy discharges until the debtor had paid off or reduced his existing debts out of future income was suggested almost 50 years ago, it was branded as "un-American." Creditors argued then, as they do now, that the extension of consumer credit was based on future income and that affordable debt was being discharged.

The threshold test proposed by the lenders for receiving Chapter 7 relief is inherently unfair. It would have the greatest impact on those already most hurt by the serious economic problems facing our country -- lower-income people and the working poor. Black people, Hispanic Americans, other minorities and households headed by women have already been hurt most by inflation, high interest rates and unemployment. Government programs designed to meet some of the low-income family's needs have been severely cut or eliminated. Many of these individuals have no place to turn but the bankruptcy court. And the credit industry wants to force them to jump through hoops to prove that they are eligible for relief from the crushing burden of debt.

The threshold test discriminates against the individual, noncorporate debtor. The credit industry's proposals would not require corporations to continue operations for five years to pay off or reduce their debts. Only individual consumers and small business owners who often are forced to accept personal liability to obtain business loans would be put to this unreasonable test. Ironically, if these proposals become law, it would be easier for a corporation to receive bankruptcy relief than it would be for its factory workers who lose their jobs.

Denying Chapter 7 relief and essentially requiring debtors to pay off their past debts over a three-to five-year period has been characterized by some as not too far from involuntary servitude, a practice long outlawed in our society.

Even if the debtor ultimately proved in court that he was unable to pay off his debts with future income, he would have been subjected to lengthy and costly litigation at a time when he was under great financial and emotional pressure.

In addition to being unfair, the future income test would be unworkable and would severely overburden the courts, leading to unequal treatment. The proposal would require bankruptcy judges to make highly speculative judgments about what a debtor's anticipated living expenses and future employment prospects would be. In the words of Judge Dean Gandy, testifying on behalf of the Conference of Bankruptcy Judges before this Subcommittee in October, 1981:

> Determinations of what is a "reasonable portion of debts" and what is "future income" could be highly speculative, would be applied in a non-uniform way throughout the country, and even between different debtors in the same court.

Another concern expressed by the Conference of Bankruptcy Judges was that litigating debtors' eligibility for Chapter 7 relief would further strain the limits of the already crowded bankruptcy court dockets. Judge Gandy also stated at the October, 1981 hearing:

> Motions raising this issue [eligibility for Chapter 7 relief] could be expected to flood the bankruptcy courts. Those courts are now extended beyond all reasonable limits, and this added anticipated deluge could not be handled with justice and dispatch. . . [C]ases will have to be postponed, or given only a cursory look. If they are postponed, the debtor would have no relief, and if they are given only cursory consideration, many errors could result.

Neither debtors nor creditors would benefit under such crowded court conditions. Hundreds of additional bankruptcy judges and attendant personal would be required to handle this additional litigation.

The industry's proposals are also designed to wipe out many of the protections afforded debtors by the 1978 legislation. One such protection is the presumption in favor of awarding attorney fees to a debtor who prevails against a creditor's challenge of dischargeability of a debt. This protection was in direct response to the credit industry's practice of routinely challenging the dischargeability of a debt in the hope of forcing a debtor to settle to save attorney's fees.

The creditors now propose to tip the scales in their favor by restricting the power of the court to assess attorney fees against creditors who frivolously object to discharge of debts and to a debtor's eligibility for Chapter 7 relief under the proposed test. Combined with the "anticipated future income" test, the attorney fees provisions would place an intolerable burden on debtors. Not only would the distraught debtor be forced to go through the lengthy, humiliating and costly experience of proving he was too poor to pay his debts, but even if he won, he could be forced to pay the cost of that litigation.

Without being faced with the possibility of paying the debtor's attorney's fees, creditors would be likely to challenge every Chapter 7 bankruptcy filing. Standard forms could be used and the costs -- deductible as a business expense -- would be relatively low.

There could not be a worse time to make sweeping changes in the bankruptcy laws. The people most in need of bankruptcy relief -- low-income families, minorities, households, headed by women -- have been hit time and time again during the past four years with economic hardship. First, the ravages of inflation and high interest rates made it difficult to make ends meet. Layoffs and rising unemployment then made a shaky future even less secure. Government programs designed to help those in economic difficulty were systematically cut back or eliminated. It is surprising that bankruptcies increased? Unable to provide even the basic necessities for their families, much less pay outstanding bills, many debtors were forced to turn to the bankruptcy courts for relief.

The arguments used by the creditors to justify their proposals do not hold water. The credit industry cites as justification the increase in the number of personal bankruptcies and a study that claimed many debtors filing Chapter 7 petitions could afford to pay at least a portion of their debts. Bankruptcies have increased during the past four years as our country has gone through difficult economic times. Inflation, high interest rates, rising unemployment and lawyer advertising are more to blame for the rise in bankruptcies than any change made by the 1978 Bankruptcy Reform Act.

And the credit industry itself must bear some of the responsibility for the rise in bankruptcies. The banks, finance companies, and retail establishments that now deplore the rise in bankruptcies are the same institutions that for years encouraged consumers to borrow more and buy more on credit through slick promotions and expensive advertising campaigns. As Judge Beryl MacGuire testified before the House Subcommittee on Monopolies and Commercial Law on March 23, 1982:

> The extend to which the credit industry has encouraged consumers to use credit is well known. At least until recently it apparently has been more profitable for credit lenders to extend credit indiscriminately and then to pass losses along to other users.

The rise in bankruptcies may not be as serious as the credit industry would have us believe. Bankruptcy filings as a percentage of credit outstanding have remained stable over the past several years. In fact, consumer bankruptcies in relation to credit outstanding are not as severe as in previous recessions. In 1975, for example, during a shorter recession than the current one, there were 100.5 bankruptcies per $100 million credit outstanding. In 1980 there were only 81.6 bankruptcies per $100 million of consumer credit.

The second argument advanced by the credit industry -- that many individuals whose debts have been discharged through bankruptcy could repay at least a substantial portion of these debts out of future income -- is based on the results of a study done by the Credit Research Center at Purdue University. However, the study was commissioned and paid for by the credit industry. Many bankruptcy specialists dispute the claims made by the study, and the Credit Research Center has refused to make the raw data available for study by those who question its results.

The Leadership Conference certainly believes that borrowers should pay their debts, whenever possible. We realize that there may be flaws in the bankruptcy laws that need to be corrected. However, the credit industry's radical proposals would overturn a century of bankruptcy tradition, prevent the overburdened debtor from obtaining a fresh start and abolish needed protections from creditor abuses given debtors by the 1978 Bankruptcy Reform Act.

The proposals made by the credit lobby go beyond this. These proposals would deny personal bankruptcy relief to those who are suffering the most in this recession -- low-income families, the working poor, and minorities. These people need help. To close the only avenue for them to discharge their debts and begin life anew free from the burden of past economic misfortune would be unconscionable.

We urge the Congress to turn its attention to a more urgent task -- the restoration of a system of adjudicating bankruptcies that will meet the constitutional standards set out by the Supreme Court. When that task is completed, we are confident that Congress can pinpoint areas in need of reform without adopting the harmful blunderbuss approach of the credit industry.

National Association of
Federal Credit Unions
P.O. Box 3769
Washington, DC 20007
703/522-4770

January 21, 1983

The Honorable Robert Dole
Chairman
Subcommittee on Courts
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

On behalf of the National Association of Federal Credit Unions (NAFCU), I would like to express our appreciation to you and the members of the Subcommittee for holding hearings on the important issue of consumer bankruptcy. As you know, this is an issue that has been examined and discussed extensively for the past two years. It is our hope that this matter can be resolved during the 98th Congress.

We respectfully request that this letter and the enclosed statement be included in the official hearing record of your Subcommittee on Courts. If you would like to discuss this matter further, please do not hesitate to contact me or our director of government affairs, Bill Donovan.

Sincerely,

John J. Hutchinson
President

JJH/yk

Enclosure

STATEMENT OF THE NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS (NAFCU)

We appreciate the opportunity to appear before you today as this subcommittee reviews standards for declaring personal bankruptcy under the terms of the Bankruptcy Reform Act of 1978. As you know, the National Association of Federal Credit Unions is the only national organization exclusively representing the interests of credit unions chartered by the federal government. There are approximately 12,700 Federal credit unions throughout the country representing more than 30 million consumer members.

THE UNIQUE NATURE OF CREDIT UNIONS

Federal credit unions are unique among our nation's regulated depository institutions since every Federal credit union is a member-owned cooperative association organized for the specific purpose of "promoting thrift among its members and creating a source of credit for provident or productive purposes." (12 U.S.C. 1752(1)). In fact, the preamble of the Federal Credit Union Act states unequivocally that Congress, in its wisdom, chose "to establish a Federal Credit Union System ... to make more available to people of small means credit for provident purposes through a national system of cooperative credit; thereby helping to stabilize the credit structure of the United States." (12 U.S.C. 1751).

Since passage of the Federal Credit Union Act in 1934, credit unions have consistently met their dual statutory mandate to promote thrift among, and provide credit to, their members. At year-end 1980, Federal credit unions held 36.5 billion dollars in member savings and had 25.3 billion dollars outstanding in loans to their members. I should note that for many borrowers their credit union often has been the only source of consumer credit at anything less than usurious rates. Since credit unions are member-owned, they deal fairly and honestly with their member-borrowers when extending loans. This fact was emphasized by the executive director of the Consumer Federation of America in testimony before the House Government Operations Subcommittee on Commerce, Consumer and Monetary Affairs during the last Congress. At that time the Consumer Federation noted that:

> [other lenders] have been much more reluctant (if not downright resistant) to disclosing essential terms, and offering the lowest rates to their consumers -- than consumer-owned and consumer-controlled credit unions whose support of Truth-In-Lending was based on the fact that they recognized that their terms would be more attractive to the average consumer.

This important and uniquely distinctive characteristic of Federal credit unions was more recently emphasized by the former National Credit Union Administration Board Chairman, Lawrence Connell, in a letter dated November 3, 1980, to William J. Anderson, Director of the Government Accounting Office's (GAO's) General Government Division. In that letter, Chairman Connell noted:

> We would also like to comment that credit unions, as cooperatives, are a far different type of operation than banks in size, complexity and philosophy. Generally speaking, they offer a very different approach to credit extensions.

Another obvious characteristic that distinguishes credit unions from every other consumer credit grantor is that credit unions are lending institutions completely owned by their borrowers and savers.

THE LEGITIMATE NEED FOR A "FRESH START" DOCTRINE

It must be clearly stated that the National Association of Federal Credit Unions recognizes the legitimate need for the equitable "fresh start" doctrine which is an essential element of any bankruptcy code. While responsible consumers are generally able to keep up with their financial obligations in normal times, many lack the financial resources necessary to respond to unanticipated financial emergencies. In such instances the "fresh start" available to the debtor through bankruptcy proceedings may be the only available equitable remedy.

Nevertheless, when a credit union member avails himself or herself of the legitimate "fresh start" afforded by the Bankruptcy Code and is discharged from debts owed to the credit union, all members of the credit union are directly affected. This reality affects credit unions as a class of financial institutions differently than it affects other consumer credit grantors precisely because all credit unions are by statutory definition, and in practice, member-owned cooperatives. Thus, in every instance where a credit union member fails to repay, in whole or in part, a loan extended by the credit union, every member of that credit union may suffer a direct economic injury in the form of reduced dividends, higher loan rates, and/or more restrictive loan policies.

FEDERAL CREDIT UNION EXPERIENCE UNDER THE BANKRUPTCY REFORM ACT

Because credit unions are unique in structure, composition and philosophy among our nation's regulated depository institutions, it should come as no surprise that the credit union experience in the area of member bankruptcies is also unique. Historically, credit union members have demonstrated a remarkably high degree of loyalty to their credit union. Often, credit union members have been able to obtain loans from their credit unions at reasonable rates when other lenders would turn them away. And, in the overwhelming majority of cases, the credit union borrower has recognized and fulfilled his or her contractual and moral obligation to repay funds extended in good faith.

Yet since implementation of Public Law 95-598, the "Bankruptcy Reform Act of 1978" our member credit unions have experienced a distressing increase in the number of bankruptcy petitions filed by their members. For credit unions recovering from the economic chaos of late 1979 and 1980, this increase in bankruptcy filings is causing severe financial pressures. While such a collective increase in bankruptcy filings in certainly significant in and of itself and appears to mandate a review of the Bankruptcy Reforrm Act, a closer look at the experience of individual credit unions is far more disturbing. As the manger of one credit union wrote:

> The statistics are interesting and certainly bear out our contention that bankruptcy is a problem. You will note that we had almost as many bankruptcies in 1980 as we had before that for our entire [44-year] history ... While the dollar statistics are bad enough, they really do not tell the whole story since

> many hours of time and lost effort are devoted to activity of this type which doesn't really show up on the balance sheet.

Another credit union manager whose losses due to bankruptcies increased three-fold from 1979 to 1980 wrote:

> We believe that many people who are not insolvent are now using the Bankruptcy code as a means to simply eliminate their obligations. In our opinion it is a legalized rip-off. There should be a specific process to determine whether individuals have a means to repay their obligations without taking advantage of the bankruptcy code. It should be emphasized that financial institutions have to pass along their losses to the other customers and the whole process is unfair to the vast majority of people who meet their obligations.

A third credit union manager, whose comments were echoed by many other NAFCU members, commented:

> Many of our members have had seemingly no financial problems, then filed for bankruptcy ... Many had sufficient income and could have worked out their problems with financial and budget counseling, but due to the ease of filing bankruptcy chose to take that method ... All had secure jobs and regular incomes.

Mr. Chairman, let me remind you that the experience I am describing to you is the credit union experience under the Bankruptcy Reform Act. It is the experience of member-owned cooperatives, which historically have had a high degree of member loyalty. With credit unions suffering increased losses due to the new Act, we see credit unions being forced to reduce dividends, charge higher loan rates, and implement more restrictive loan policies.

RECOGNITION OF THE PROBLEM BY GOVERNMENT OFFICIALS

It is particularly noteworthy that in November, of 1980, the Senate found it necessary to appropriate an additional 1.2 million dollars to handle the unanticipated increased burden upon Bankruptcy Courts which resulted from the

October 1, 1979 implementation of the Bankruptcy Reform Act. On November 12, 1980, William E. Foley, the Director of the Administrative Office of the United States Courts, wrote to Senator Ernest Hollings (D-SC):

> Dear Mr. Chairman: I regret that at this late date I must ask you and your Committee ... to provide an additional $1.2 million ... for the employment of temporary personnel for the clerks' offices in those [Bankruptcy] courts ... The budget estimate for fiscal year 1981 which was submitted in October 1979, contemplated 255,000 bankruptcy case filings. The current estimate of filings for fiscal year 1981 is 475,000 cases (estates) and there would appear to be no evidence that the rate of filings will subside any time in the near future. This increase in filings, in large measure, is due to the liberalized provisions of the Bankruptcy Reform Act of 1978 as well as the removal of restrictions on advertising by attorneys who practice bankruptcy law ... The increase in bankruptcy filings has had a crippling effect on the work of the bankruptcy offices.
>
> (Congressional Record, 11/12/80,
> at S 14276)

In his letter, Mr. Foley also pointed out that the sharp increase in bankruptcy filings had created "serious morale problems," clerks putting in "many extra hours of overtime" for which they were not being compensated, a "delay in the closing of cases," trustees "not being compensated on a timely basis" and trustees "refusing to accept appointments."

Evidence that the Bankruptcy Reform Act has failed to achieve its desired objectives is abundant, and our critical comments regarding certain aspects of the Code are offered today in good faith, aware that the credit unions we represent are distinguishable from all other credit grantors because our members are cooperative associations, comprised of both member savers and member borrowers. I believe that observations made by one of the principal authors of the 1978 Code -- who is also a distinguished member of this

Committee -- Senator Dennis DeConcini (D-AZ), may be of assistance in putting the question of revision of the Bankruptcy Reform Act in proper perspective. In comments made on the Senate floor December 1, 1980, Senator DeConcini noted:

> When the Code was passed in 1978, it was the largest piece of legislation in volume processed during the 95th Congress. Inevitably, errors and omissions were made in the final hectic days of that session as the Congress worked toward final passage of the code ... I must be candid ... at present there is no threshold standard a debtor must meet to go into bankruptcy. A solvent person could take advantage of the code to the detriment of creditors and the disrepute of the law in general. I would have preferred a standard of insolvency or inability to pay debts as they become due ... The preference section has been a mess ... Another issue that I would have liked to address, and will next year, is the sordid tactics employed by many lawyers in advertising their bankruptcy practice and encouraging members of the public to take bankruptcy.
>
> (Congressional Record, 12/1/80
> at S 15173)

Concern over the marked increase in consumer bankruptcies under the new Act have also been expressed by the National Credit Union Administration. On November 10, 1980, Robert H. Dugger, director of NCUA's Office of Policy Analysis, wrote to our Association:

> In recent months the trend in personal bankruptcies appears to have been rising. For consumer lenders this trend has some potentially serious consequences. As the Federal agency with regulatory and supervisory responsibility for one of the more significant components of the consumer credit sector we are concerned about

the magnitude, direction, and significance of recent bankruptcy trends.

NAFCU'S RECOMMENDATIONS

Mr. Chairman, the National Association of Federal Credit Unions urges you and your colleagues in the Congress to continue with despatch the process of review of the Bankruptcy Reform Act which you have begun today. It is our desire to continue the credit union tradition of meeting the credit needs of our members at reasonable, equitable rates. We are proud of that tradition. Unfortunately, due to the sky-rocketing number of questionable bankruptcies granted by the Courts, it has become increasingly difficult for credit unions to meet their members' requests for loans. We do not request that you remove any fundamental borrowers' rights conferred by the 1978 amendments, but to urge modification of the Act to guarantee an equitable balance between the borrowers' rights and the lenders' remedies. We ask that an element of even-handedness be added to the Act to remove apparent abuses and correct unforeseen problems. Credit unions are committed to continuing their longstanding tradition of providing loans at reasonable rates to their members, and merely ask the Congress for some degree of certainty that loans extended in good faith will be repaid by members who, in fact, have the resources to meet their moral and contractual obligations to the credit unions.

Specifically, the members of the National Association of Federal Credit Unions urge the Congress to:

1) Establish threshold criteria which must be met by a borrower before he or she may go forward in a bankruptcy proceeding. Since credit is generally extended against the borrower's ability to pay in the future, one criteria for entry into a bankruptcy proceeding should be the borrower's inability to meet his or her obligations based upon present assets as well as future income. Income in relation to debts must be considered in making any realistic determination of whether or not an individual has exceeded his or her ability to repay debts. It seems obvious that bankruptcy relief may not be necessary or appropriate merely because a borrower is experiencing temporary financial difficulties.

2) Except from discharge any debt incurred on the basis of false or fraudulent information. We recommend that this exception include instances in which such false or fraudulent information does not relate directly to the borrower's financial statement, but also to other aspects of a credit application on which a creditor bases a credit decision. For example, a creditor may rely on length of time or residence, or length of time of employment in evaluating a credit application. When such information supplied by the borrower is false or fraudulent, it seems unconscionable for the court to discharge the borrower's obligation to repay such loans.

3) Require the borrower to notify secured creditors of what he or she intends to do with secured property within ten days of filing the petition in bankruptcy, and to further require that the borrower perform his or her stated intention by the time of the first meeting of creditors. If this recommendation were adopted, I would further suggest that the judge preside over the first meeting of creditors. This would encourage the borrower and lender to settle disputes without further judicial proceedings and their attendant expenses.

4) Permit the borrower to reaffirm obligations without court approval. Since implementation of the 1978 amendements, credit union members have often been unable to reaffirm their obligation despite their desire to do so, because present law requires the bankruptcy judge to reach a finding that the reaffirmation would be "in the best interest of the debtor." This strict test frequently frustrates the wishes of the borrower to reaffirm.

5) Exclude from preference attack those transactions which are made in the ordinary course of business to creditors who lack reason to know of the debtor's insolvency. Such creditors, and credit unions often fall into this category, are unlikely to have applied the kind of last minute pressure which the preference attack is meant to guard against. In addition, the small sums involved generally would not undercut the goal of creditor equality.

Mr. Chairman and members of the subcommittee, should the Congress look favorably upon and adopt the recommendations set forth above, it is our belief that credit union members who are confronted with unanticipated financial crises will retain their ability to avail themselves of the relief inherent in the concept of bankruptcy, while significantly reducing the direct economic injury their discharge in bankruptcy inflicts upon other members of their credit unions. In addition, adoption of these recommendations will recognize the responsibility of individuals to repay affordable debt.

We thank the subcommittee for this opportunity to submit this statement for the hearing record and pledge the cooperation of the National Association of Federal Credit Unions as you continue to grapple with the difficult problems surrounding the issue of consumer bankruptcies.

DAVIS POLK & WARDWELL

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January 24, 1983

The Honorable Strom Thurmond
Chairman, Senate Committee
on the Judiciary
2226 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

This letter is in support of legislation designed to correct an oversight in the Bankruptcy Reform Act of 1978. This legislation, known in the 97th Congress as H.R. 5116 (and referred to as such here since similar legislation has not yet been introduced in the 98th Congress), passed both the Senate and the House of Representatives in the last Congress.

The full text of H.R. 5116 reads as follows:

> That Section 403(e) of the Act of November 6, 1978 (92 Stat. 2683; Public Law 95-598), is amended--
>
> (1) by inserting "(1)" after "(e)", and
>
> (2) by adding at the end thereof the following new paragraph:
>
> "(2) Notwithstanding subsection (a) of this section, a fee may not be charged under section 40c(2)(a) of the Bankruptcy Act in a case pending under such Act after September 30, 1979, to the extent that such fee exceeds $200,000.".

Background

The Referees' Salary and Expense Fund had been in existence since the 1940's. Its purpose was to impose fees on certain bankrupt estates in order to pay the cost of supporting the Bankruptcy Court system. In 1978 the Fund was recognized as an oddity which no longer had any sound rationale, and the decision was made to have the Bankruptcy Court system supported by the general treasury, just like the other Federal courts. In so doing, Congress decided that it should be the goal of the bankruptcy laws to ensure maximum return to the creditors of the bankrupt. Thus, in 1978 the Referees' Fund was eliminated.

The problem H.R. 5116 attempts to correct is the very uneven way in which Congress dealt with bankruptcies which had already begun and which were still pending on the effective date of the 1978 Act. Prior to the 1978 Act, the Referees' Fund fees had been levied only on estates in Chapter VII liquidation proceedings, Chapter XI reorganization proceedings and wage-earner plans; they were not levied in Chapter X reorganizations or in Chapter IX or Chapter XII cases. The 1978 Reform Act wiped out the fees for all future cases. For bankruptcies which were still pending, the 1978 Act put a $100,000 ceiling on the fees for Chapter XI reorganization cases but provided no such cap or other relief for Chapter VII liquidation or wage-earner cases.

Rationale of H.R. 5116

The discriminatory difference in treatment of pending Chapter XI cases and pending liquidation cases is obvious and should be eliminated, as H.R. 5116 seeks to do by placing a $200,000 cap on fees charged to pending liquidation cases. There is no acceptable rationale for the difference. (A $100,000 cap for wage-earner plans is unnecessary because the charge has never approached that size and because there should no longer be any wage-earner cases still pending under the old act.) One of the laudable goals of the 1978 Act, after all, was to ensure that an estate's assets went to the creditors who were due them rather than to the government which had no logical claim against them. But through inadvertence that purpose has been frustrated in pending liquidation cases. It makes no sense to have any bankrupt estate pay a substantial portion of estate assets to the Federal government for a Fund which is no longer in existence, particularly on the discriminatory basis where all other types of bankruptcy proceedings are either exempted altogether or protected by a ceiling on the charge.

The House Judiciary Committee Report on H.R. 5116 recognized that fact:

> "A fee ceiling in Chapter VII cases is consistent with the underlying rationale of present Section 403(e) and with Congressional action in eliminating the fee for all cases brought after September 30, 1979. The fees which are assessed in these cases and paid into the now-abolished Referees' Salary and Expense Fund should be limited to some reasonable amount in order to maximize the return of the assets of the estate to the creditors."
> (House of Representatives Report No. 97-415, p. 3)

H.R. 5116 affects at least three pending Chapter VII cases, as Congressman Edwards stated during floor debate:

> "The bill would place a $200,000 cap on the fees owing in at least three chapter VII liquidation cases pending under the old Bankruptcy Act -- In re W. T. Grant, involving fees of $20 million; In re Associated Transport, Inc., $1.5 million in fees; and In re Eastern Freight Ways, Inc., $500,000 in fees.
>
> ******
>
> "Mr. Speaker, the gentleman from Illinois (MR. HYDE) is correct. There are other creditors. There are wage claimants; there are former employees who have a pension and welfare fund, and most of these employees are

> each owed over a $1,000."
> (Cong. Rec. December 16, 1981, pp. H9805-07.)

There is no way of knowing for certain, but it is very likely that there are other Chapter VII cases pending, in addition to the three specified in the report and hearings.

It was well known at the time of the 1978 Act that there were large-asset Chapter XI cases pending. The Congress placed a cap on such cases, but the Congress did not give consideration to pending Chapter VII cases. If the Congress had focused on the Chapter VII problem, it is virtually certain that it would have placed a similar cap on fees payable on those cases.

The House Judiciary Committee report on H.R. 5116 strongly supports this conclusion:

> "Congress was not aware of any such extraordinarily high fee cases under Chapter VII. No large-asset Chapter VII cases were brought to Congress' attention at the time of the 1978 legislation, and Chapter VII liquidation cases generally do not generate extremely large fees. Chapter XI reorganization cases are usually larger than straight bankruptcy cases and therefore generally produce much higher fees." (House of Representatives Report No. 97-415, p. 2.)

In fact, never in the history of the Fund had there been fees even approaching the magnitude of those arising from the three pending cases cited above. The combined fees in those three cases, under the present law, total more than $22 million. Yet in all of 1977, the last year for which figures are available from the Administrative Office of the U.S. Courts, the Fund received only $7,630,861 from a total of 30,850 Chapter VII asset cases. The average fee for 1977 was $247. It is therefore clear that the Congress in 1978 could not have foreseen a situation in which the fees from three pending liquidation cases would be triple the entire amount the Fund received the preceding year from more than 30,000 cases.

The 96th and 97th Congresses

Both the House and Senate have separately recognized the inequities inherent in this situation and both have approved bills containing provisions identical to the one now under consideration. On September 22, 1980, the House passed its version of the bankruptcy technical amendments bill (S. 658) containing just such a provision (with a $100,000 cap on fees). The provision moved through the Judiciary Committee and the House floor without objection. However, there were serious differences between the House and Senate on other, unrelated aspects of S. 658, which prevented the bill from becoming enacted in the 96th Congress.

During the 97th Congress, the Senate passed on July 17, 1981, without objection, another version of the bankruptcy technical amendments bill (S. 863), which contained a provision identical to H.R. 5116. Because members of the House Judiciary Committee objected to other, unrelated features of S. 863, however, H.R. 5116 was introduced as a separate measure by Reps. Edwards of California, Rodino of New Jersey, Railsback of Illinois and Evans of Georgia. The bill was favorably reported and recommended for passage by the House Judiciary Committee and subsequently was passed by the full House of Representatives on December 16, 1981. After being sent to the Senate, the bill was referred to the Senate Judiciary Committee, where together with other bankruptcy legislation it fell victim to the impasse over the bankruptcy judges dispute. Thus, both houses of Congress have independently passed measures which recognize and correct the inequity created by oversight when the 1978 Act was enacted.

We therefore respectfully request that the language of H.R. 5116, which during the last Congress was without controversy in the Senate Judiciary Committee, be incorporated in the first bankruptcy legislation to be acted upon by the Committee.

Thank you for your consideration.

Sincerely,

Philip C. Potter Jr.

Philip C. Potter, Jr.

SUBMISSION RELATING TO REPURCHASE AGREEMENT CODE AMENDMENTS

WRITTEN STATEMENT OF THE INVESTMENT COMPANY INSTITUTE BEFORE THE SUBCOMMITTEE ON COURTS OF THE SENATE JUDICIARY COMMITTEE ON PROPOSED TECHNICAL AMENDMENTS TO THE BANKRUPTCY REFORM ACT OF 1978

February 7, 1983

The Investment Company Institute ("Institute") submits this statement in support of the repurchase agreement amendments to the Bankruptcy Reform Act of 1978 ("Code") which would exempt certain repurchase transactions ("repos") from the automatic stay and avoidance provisions of the Code. These amendments are contained in S. 445 which is presently being considered by the Senate Judiciary Committee. The amendments have been endorsed by the Federal Reserve System, numerous financial and securities institutions, and securities and banking trade associations, all of whom have a vital interest in a viable repo market.

The Institute is the national association of the mutual fund industry and includes in its membership 801 open-end investment companies (mutual funds) registered under the Investment Company Act of 1940, with assets, as of December 31, 1982, of $274.3 billion and approximately 17 million shareholders. This accounts for over 91 percent of the assets of all mutual funds.

Money market mutual funds constitute a significant portion of the mutual fund industry. There are 281 money market funds, whose assets are invested in short-term money market instruments such as securities issued by the U.S. Government and its agencies and instrumentalities, certificates of deposit issued by banks, bankers acceptances, commercial paper and similar instruments.

Repurchase or "repo" agreements are commonly used by money market funds on a short-term basis due to the ease with which dollars can be invested and the recognized safety of the repo transaction by sophisticated participants in the financial markets. However, repos also perform an important liquidity function in the investment portfolios of money market and other mutual funds where they are commonly used as an important method of meeting anticipated needs for cash. As of December 31, 1982, the 281 registered money market funds held repo agreements totaling approximately $16.2 billion. 245 of these funds are members of the Institute. As of December 31, 1982, money market Institute member funds had net assets of $186.0 billion, which constitutes 90 percent of total money market fund assets. Shares in these funds are owned by approximately 10 million shareholders.

It is vitally important to the members of the Institute, and in the public interest and the interest of investors, that the Code be amended to protect the repo market from the serious disruptions which could emanate from the bankruptcy of a government securities dealer or other party holding repos under the Code's present provisions.

Under the Investment Company Act, mutual funds are required to stand ready at all times to redeem shares held by investors, except in specified emergencies. It is absolutely essential, both as a legal and a practical matter, that mutual funds maintain a degree of liquidity sufficient to meet the daily flow of redemptions from shareholders. This is especially true of money market funds which, by their nature, are required to be very highly liquid and are used by millions of investors on a daily basis for investment in and redemption of fund shares. The ability to redeem promptly, at net asset value, is crucial to the operation of these funds and the maintenance of investor confidence. For the twelve months ending December 31, 1982, money market mutual funds experienced redemptions of $560 billion of their shares. During the month of December, 1982, redemptions of shares in these funds reached $73 billion.

The recent failure of Drysdale Government Securities Inc., and the filing of Chapter 11 proceedings under the Code by Lombard Wall Incorporated, another government securities dealer, have generated considerable uncertainty about the treatment of repos under the Code. Essentially, a party holding repo securities runs the risk that it might not be able to liquidate the securities immediately upon the insolvency of the other party, and that margin payments, or amounts received in closing out a repo transaction, might be deemed voidable preferences under the Code. In the past, the repo market has functioned efficiently and well, especially considering its enormous volume and large number of participants. Concern about a possible bankruptcy filing by a repo market participant can only constrict the market and adversely impact those financial institutions which rely on repos to serve their specific needs. It should be noted that a number of these institutions are subject to investment restrictions which may result in these institutions reevaluating their participation in the repo market if legislative relief is not forthcoming.

It is important to note that mutual fund utilization of this very important investment vehicle has decreased in recent months. Outstanding repurchase agreements of money market funds totaled approximately $22.1 billion at the end of August, 1982 and represented approximately 9.7 percent of fund assets. At the end of December, outstanding repos were estimated to be about $16.2 billion, $5.9 billion less than the August peak; outstanding repos as a percent of total assets fell to 7.8 percent. The current negative publicity and legal uncertainties surrounding repos have created an environment which could further reduce fund participation in the repo market.

Since proper use of repos helps the money market funds achieve liquidity and meet shareholder redemption requests, such a result would not be in the best interests of the shareholder public. There is no reason that mutual funds and other institutions with short-term liquidity needs should not be able to engage, with maximum safety, in very short-term transactions, rather than hold fallow cash. The repo amendments would allow this participation by amending the Code to assure that participants in the repo market are afforded the same treatment with respect to the stay and avoidance provisions of the Code, in connection with certain repurchase agreements, that Public Law 97-222, enacted July 27, 1982, explicitly provided for stockbrokers, securities clearing agents, commodity brokers and forward contract merchants in connection with securities contracts, commodity contracts and forward contracts. At present the Code can be read to cover certain participants in the repo market, such as stockbrokers, and not others. The repo amendments would protect the contractual rights and obligations of parties to repos, and would not expand substantive contract law.

The Institute recognizes the legitimate interests of debtors and the importance of the Code's statutory scheme which is designed to protect both debtors and creditors. However, in the case of repos, as with the case of securities contracts and the parties protected by Public Law 97-222, the certainty and fluidity needed by professionals on both sides of the transactions is of such importance that one debtor's filing of a petition should not be permitted to impair the functioning of the market as a result of the Code's automatic stay, or have the integrity of contract relationships upset by the Code's avoidance provisions.

Perhaps even more importantly, the repo market is an integral part of a sophisticated system through which small investors assist in financing the national debt. Savings bonds, which traditionally have served this function, are no longer a viable option for the millions of investors desiring a better return on their investment dollars. Government securities money market funds, which utulize repurchase agreements, have provided investors with this higher return while at the same time keeping their investment dollars invested in government securities. The development of this system is a classic example of private industry and the government working in tandem to achieve a laudable social goal. Now, as a result of a small, unintentional "glitch" in the law, this entire system through which important public needs and legitimate private interests are being well served, may be unnecessarily disrupted. If the legal uncertainties surrounding repos are not resolved, it might be necessary to develop less efficient and more costly substitutes. The Institute believes that the repo amendments are the answer to this problem.

It should be stressed that the repo amendments are technical, non-controversial, and could be enacted at no cost, but with some benefit, to the government. Therefore, we respectfully urge that they be enacted as soon as possible.

SUBMISSIONS RELATING TO SHOPPING CENTER TENANCY AMENDMENTS

STATEMENT OF THE
BUILDING OWNERS AND MANAGERS ASSOCIATION INTERNATIONAL
ON THE
SHOPPING CENTER TENANT AND BANKRUPTCY
PROTECTIONS IMPROVEMENTS AMENDMENTS

SUBMITTED BY

GARDNER S. McBRIDE
EXECUTIVE VICE PRESIDENT

February 1, 1983

The Building Owners and Managers Association (BOMA) International supports the proposed Shopping Center Tenant Bankruptcy Protection Improvements Act. Our association believes that the proposed amendments would strengthen and improve the protections under the Bankruptcy Code for financially solvent tenants now occupying buildings owned and managed by BOMA members.

The Building Owners and Managers Association International is a 75 year old organization representing 5,000 owners and managers of commercial and retail space, in over 70 cities across the United States. BOMA, through its membership, represents over 1 billion square feet of commercial office and retail space throughout the nation. Many of our members own and operate shopping centers and retail facilities in office buildings.

Our members overwhelmingly support changes in the Bankruptcy Code because of the negative effect of the existing law on the solvent tenants in our members' buildings.

Under the Bankruptcy Code, many of our tenants have experienced financial difficulties brought on when a neighboring tenant files for bankruptcy. These difficulties have arisen because:

- lease agreements preserving a carefully chosen tenant mix are frequently ignored. This jeopardizes the business of the other tenants and detracts from the value of the tenant's lease; and
- long term vacancies, the deterioration of a bankrupt tenant's commercial space, and the bankrupt tenant's failure to pay its rent, taxes and other charges when due, impair the viability of the solvent tenants.

To accommodate and safeguard the assets of the financially solvent tenants, the protections in the Bankruptcy Code must be improved.

The amendments proposed last year in the Shopping Center Protections Improvements Act of 1982 would provide the following protections for our members' tenants:

- assure that a mix of tenants, consistent with lease provisions, would be preserved;
- assure that the solvent tenant would have a lease that would not be devalued by vacant, partially operated or deteriorating space for an extended period of time; and
- require the timely performance of the tenant's obligations under the lease.

The adoption of these provisions is important to the financial well being of the 5,000 building owners and managers represented by BOMA and their tenants.

If the Committee desires additional information as to the importance of these amendments to BOMA members, I would be more than happy to provide such information for the record.

Thank you for allowing me the opportunity to submit these comments to the Subcommittee.

Statement of
The National Association of Industrial and Office Parks

Presented by

Carlos E. Fonts

President, Brookhollow Corporation
and
Chairman, NAIOP Public Affairs National Committee

On behalf of the National Association of Industrial and Office Parks (NAIOP), I welcome this opportunity to comment on the effort of the Senate Subcommittee on Courts and the Senate Committee on the Judiciary to amend Title 11 of the United States Code as it relates to executory contracts and unexpired leases in the event that a tenant files for bankruptcy. The NAIOP is a membership organization comprised of more than 2500 commercial and industrial developers, many of whom develop and maintain proprietorship of their own commercial property. The membership roster of NAIOP represents over $60 billion worth of industrial, office and commercial real estate holdings.

Last year, Senators Hatch and DeConcini introduced S 2297, the Shopping Center Protections and Improvements Act of 1982. The legislation was intended to clarify Congress' intent when it enacted Section 365 and subsequent subsections of the Bankruptcy Reform Act of 1978. Prior to enactment of the 1978 Act, property lessors were generally able to protect their interests and the interests of their other tenants by enforcing lease clauses permitting the lessor to regain control of his leased space if his tenant filed for bankruptcy. The 1978 Act invalidated this practice and also liberalized the contractual constraints of the trustee.

While it is understood that Section 365 of the 1978 Act attempted to address the problems that shopping center owners, building owners, and owners of industrial parks might experience when dealing with a bankrupt tenant, the

1978 Act falls short of the author's goals. As a result of the Bankruptcy Reform Act of 1978, it has become possible for the trustee or the debtor-in-possession to:

1) fail to decide whether he wishes to assume or reject the lease for an extended period of time , and to leave the premises unused or partially unused to the detriment of the surrounding businesses and the building owner;

2) fail to perform his obligations under the lease when due, including the payment of rent and other charges; and

3) fail to assign his lease to an assignee who will honor the original use clauses of the lease.

It is obvious that the shortfalls of the 1978 Act work to the detriment of those surrounding tenant businesses whose existence is dependent on the harmonious interworkings of the shopping or business complex. Once a tenant has filed for bankruptcy, the owner of the complex is faced with immediate and costly problems.

On behalf of America's industrial and office building developers and owners, I would like to address some of the more urgent problems which we face in this context.

> First. The 1978 law was enacted to assist in easing the economic severity of bankruptcy on secondary institutions. In many cases, however, it has become a cause for a second bankruptcy. The building owner--an innocent victim--is left with unusable space for many months. In cases where the building is a single user occupied building, this means that no money is being paid on the building. For a small building owner without the resources from other businesses, this can cause the loss of the building to the financial lender.
>
> Second. Even to the owner of a multi-tenant building, the loss of revenue can be extreme. A small office of 20,000 square feet which brings in $24 per square foot would cost the owner $24,000 for just a six-month period. For many owners, this is more than the total profit of the building.
>
> Third. In the case of developers of office or industrial parks there is an additional loss not faced by many retail developers. When a retail space is vacated, its availability is readily apparent to all surrounding businesses.

> It is also in all of the surrounding business' interest to get that space re-leased as soon as possible. This is not so with industrial or office space. Usually this space is not visible (and, therefore, there is little secondary marketing support), and it is seldom economically related to the surrounding businesses, so there is little incentive to support a quick re-leasing.
>
> Fourth. Unless a lease is terminated by law when bankruptcy is declared, lease ownership (in the sense of final tenant decision) is placed in the hands of individuals who have no permanent interests in the building as a whole over the period of its lifetime. It is placed in the hands of individuals making decisions about immediate problems unrelated to the space itself. This is an unfair burden on all parties concerned--trustees, the actual owner, and the other tenants who must live with the consequences of a good or bad decision which affects their own interests.
>
> Fifth. Idle building space is unused potential for new business start-up. Many times older space is less expensive than newer space in the same vicinity. When the older space is available but not occupiable, the newer, more expensive space must be used by start-up businesses rather than the normal upgrading of location desired by established businesses. Thus, the "freed up" space which is less expensive cannot be used by business ideas not well financed enough for the more expensive space which they must then take.
>
> Sixth. Finally, in the colder areas of the country vacant space must continue to have utilities such as heating to prevent freezing--and therefore breaking--of water and sprinkler systems. Also, building owners are faced with continuing the maintenance of grounds and parking lots. This means that not only is the space vacant and not producing income for the owner, it is also costing the owner an actual cash outlay during the entire period of its vacancy.

The Hatch/DeConcini bill, S 2297, would have eliminated these six problem areas had the bill been enacted. They introduced a legislative remedy:

1) mandating that a trustee decide within 60 days whether to assume or reject the responsibilities of the tenant's lease;

2) requiring that bankruptcy trustees pay the rent, security fees, parking lot maintenance, etc., during the 60-day decision period; and

3) maintaining that businesses taking over the unexpired lease of a bankrupt tenant comply with the original use clauses of the lease.

Although the Shopping Center Protections and Improvements Act was not enacted, it did call attention to an ever increasing problem faced by building owners when confronted with tenant bankruptcy. As the economy suffers recessionary trends, so do the owners and tenants of business complexes. This makes the need for legislation that can solve these problems even more urgent.

The National Association of Industrial and Office Parks last year was on record in support of the Hatch/DeConcini legislation. Let me restate that support now for any legislation which may be introduced during this session of Congress which would have the effect of eliminating these punitive measures against the owners of commercial properties. I urge your consideration and place the Association as a willing participant in the development of such legislation or in continuing to urge its enactment by the various legislative bodies through which it must pass in order to become law.

STATEMENT OF THE
NATIONAL REALTY COMMITTEE
ON
SHOPPING CENTER TENANT BANKRUPTCY PROTECTIONS IMPROVEMENTS

I. The National Realty Committee

The National Realty Committee (NRC) submits this statement in support of legislation which would amend the Bankruptcy Code to improve the protections for solvent shopping center tenants and shopping centers in the event of a tenant bankruptcy. This legislation passed the Senate last year as the Shopping Center Protections Improvements Act of 1982, S. 2297, and was included in the omnibus bankruptcy package under consideration in the Senate last year as the Leasehold Management Amendments.

National Realty Committee, Inc. is a non-profit business league whose membership includes owners, operators and developers of all types of real estate throughout the United States.

Many of the NRC's members are developers or owners of leased commercial property, including shopping centers.

II. Problems Under the Bankruptcy Code

Under the Bankruptcy Code, which has been in effect since 1979, solvent tenants and landlords have encountered a number of problems as the result of the administration under the Bankruptcy Code of the leases of insolvent tenants. The major problems have been:

1. The abandonment or inadequate operation of leased space for an extended period of time, with the landlord unable to regain control of the property;

2. The bankrupt tenant's failure to perform its obligations under the lease, including its payment of rent and other charges;

3. The use of leased space in ways not permitted by the lease following the assumption or assignment of the lease; and

4. The assignment of leased space to a new tenant which is itself financially unsound and likely soon to become involved in a bankruptcy proceeding.

This legislation deals with these problems by making the following changes in the Bankruptcy Code:

1. Trustees would be required to assume or reject a lease within 60 days after the filing of the bankruptcy petition, unless the court extends this time for cause;

2. Until the lease is assumed or rejected, the trustee would be required to perform the obligations of the tenant under the lease, including the payment of rent and other charges, unless the court extends the due date for such payments during the first 60 days after filing the bankruptcy petition;

3. Any use restrictions in a lease must be adhered to if the lease is assumed or assigned; and

4. If a lease is assigned, the assignee must have a financial and operating performance similar to that of the original tenant when the lease was executed.

None of these changes affect the basic policy established in the 1978 Act of permitting the debtor to retain leased premises. These changes would make effective another policy established by the 1978 Act, that of protecting other tenants and landlords in the event that a debtor chooses to retain control of its lease.

The National Realty Committee strongly supports this legislation and urges its expeditious enactment.

STATEMENT OF

GEORGE LAMBROS

MANAGING PARTNER AND OWNER, SOUTHGATE MALL

ON

THE SHOPPING CENTER TENANT BANKRUPTCY PROTECTIONS IMPROVEMENTS ACT

FEBRUARY 3, 1983

I. INTRODUCTION

My name is George Lambros. I am the Managing Partner and owner of the Southgate Mall, located in Missoula, Montana. The Southgate Mall is an enclosed shopping center of approximately 465,000 square feet with four department stores and 91 smaller shops. I've been in the shopping center business for 23 years and have owned and operated the Southgate Mall for five years.

Last year, I testified before the Subcommittee in support of the Shopping Center Protections Improvements Act of 1982, S. 2297. In my testimony last year, I discussed one of the provisions of the bill which would delete the word "substantially" from the provisions in the Bankruptcy Code which require that the a trustee in bankruptcy not violate provisions of a lease or disrupt a shopping center's tenant mix in the assignment or assumption of a lease.

Section 365 of the Bankruptcy Code provides that adequate assurances of future performance under an unexpired shopping center lease must be made in order for the trustee or debtor-in-possession to assume or assign such a lease. Section 365(b)(3)(C) provides that adequate assurance of future performance under the lease must include an assurance "that assumption or assignment of such lease will not breach substantially any provision, such as a radius, location, use, or exclusivity provision, in any other lease, financing agreement or master agreement relating to such shopping center..." Section 365(b)(3)(D) provides that there must also be an adequate assurance "that assumption or assignment of such lease will not disrupt substantially any tenant mix or balance in such shopping center."

The purpose of my testimony last year was to explain to the Subcommittee the great care with which a tenant mix in a shopping center is chosen and the extreme importance of maintaining that tenant mix. I submitted along with my testimony the Tenant Mix Evaluation for the Southgate Mall showing how the businesses in the shopping center are balanced by categories, and within each category by subcategories. A copy of the current Tenant Mix Evaluation of the Southgate Mall is attached to this statement.

I testified last year because of my awareness of the importance to a shopping center and all of its tenants of maintaining an appropriate tenant mix and of the great harm that could be done to the shopping center and its tenants if that mix were disrupted because of any reason, including the operation of the Bankruptcy Code. At that time, my testimony was based on my long experience in the shopping center industry, and I had had no personal experience with the assignment of a lease in my shopping center under the Bankruptcy Code.

Since testifying last year, however, my worst fears regarding the misassignment of a lease under the Bankruptcy Code have been realized. The trustee of a bankrupt tenant has sought to assume and then assign the lease of space in my shopping center, the Southgate Mall, to a new business. This business would violate the use clause of the lease, and would substantially disrupt the tenant mix in the shopping center. This disruption would harm the other tenants, especially those adjacent to the bankrupt tenant's space.

The very problems with the language of the Bankruptcy Code which I highlighted in my testimony last year were "reluctantly" relied upon by the bankruptcy court in permitting this assignment. This situation, which I will describe below, provides only one example of how debtors and trustees use the ability of a bankrupt shopping center tenant to assume and then to assign a shopping center lease, in violation of the use clause and to the detriment of the other tenants, in order to unjustly create an asset for the benefit of the debtor's insufficiently secured creditors at the expense of the other tenants in the shopping center.

II. PROPOSED ASSIGNMENT OF SOUTHGATE MALL LEASE TO A BUSINESS IN VIOLATION OF THE USE CLAUSE AND DETRIMENTAL TO THE BUSINESS OF THE OTHER TENANTS

On November 7, 1977, the Southgate Mall leased 2,946 square feet of space to Slacks, Inc., the owner and operator of a clothing store called "BO-LEGS." The use clause of the lease (attached to this statement and identified as "Exhibit B") states that the premises may only be used for "a retail clothing store engaged primarily in the sale of unisex tops... and pants... as well as other items considered to be... fashionable clothing or fashionable accessories..." BO-LEGS operated this store under this use clause until it became insolvent and closed in July 1982.

In August 1982, a group of investors offered to purchase the BO-LEGS lease, at the rent being paid by BO-LEGS, but for a new use--the operation of a combination electronic game arcade and pub and sandwich business. Southgate Mall informed the trustee that the inclusion of such a tenant in the mall would be detrimental to the shopping center as a whole and especially to the adjacent tenants. We made clear to the trustee that we had no desire to frustrate the assumption and assignment of this lease and would cooperate on any proposal which would not harm the shopping center. However, rather than looking for a suitable replacement tenant, the trustee applied to the bankruptcy court to assume the unexpired lease of BO-LEGS and assign it to the arcade-pub-sandwich shop.

We objected to this assignment on the following grounds:

1. The use of the BO-LEGS space by a non-clothing store would violate the use clause of the lease to be assigned and would substantially disrupt the tenant mix of the shopping center;
2. The two tenants on either side of the BO-LEGS space are fashionable women's wear stores, complementary uses to the BO-LEGS retail clothing store. These tenants would be financially damaged by the loss of a complementary tenant occupying the BO-LEGS space;
3. The adjoining stores also would be damaged financially by the use of the space for an arcade-pub-sandwich shop because such use would markedly change the image of that part of the shopping center and would bring to the center certain problems peculiar to the operation of arcades;
4. The shopping center already has one arcade tenant. The inclusion of a second arcade in a medium sized mall such as Southgate would be detrimental to the business of the entire shopping center;
5. The existing arcade tenant would be unfairly disadvantaged because the customer traffic in the shopping center will not support adequately two arcades, and because the existing arcade tenant

pays a rent which is over 60% greater than that which the new arcade tenant would be paying under the BO-LEGS lease;

6. Several of the existing food service establishments in the shopping center are in financial difficulties, and the addition of additional food service facilities may drive some of the businesses into insolvency.

A. Violation of the Use Clause of the Lease to be Assigned

1. The Use Clause: Why the Developer Demands It and What He Pays For It

As described on page 3, the use clause of the BO-LEGS lease is quite specific regarding the way in which its space is to be used. This use clause significantly restricts the ability of the tenant in the operation of its business. In order to get the tenant to agree to such a restriction in a lease, it is necessary for the shopping center developer to make concessions, such as accepting less rent.

Shopping center developers make such concessions because they believe that the success of the entire shopping center depends upon the establishment and maintenance of an appropriate tenant mix. It is in the direct financial interest of the shopping center developer to promote the success of all of the tenants of the shopping center because shopping center developers typically receive a percentage of net sales, in addition to receiving a base rent. For example, in the BO-LEGS lease, the shopping center would receive either a base rent of $8 per square feet or 5 percent of the net sales of BO-LEGS, whichever is greater.

The $8 per square foot base rent is less than the average rent paid by a tenant in the Southgate Mall. BO-LEGS received this favorable rental rate for three reasons. First, because it agreed to restrict the use of its space. Second, because it was a clothing store, and such stores are profitable to the shopping center because they attract the type of shoppers who make up the bulk of the traffic to a shopping center. Third, the inclusion of a store such as BO-LEGS in a shopping center will cause an increase in the customer traffic to the other tenants, and the sales generated by such traffic will increase the landlord's percentage rent from the other tenants.

2. Grounds for Violating the Use Clause

The bankruptcy court permitted the bankruptcy trustee to ignore completely the use clause of the BO-LEGS lease. The Trustee proposed to assign the lease to an arcade, a business which would not attract a clientele likely to patronize the other tenants of the shopping center, but which would attract a clientele likely to disrupt the business of the surrounding clothing store tenants.

One argument made by the trustee in support of this violation of the use clause was that under the language of Section 365(b)(3)(C), only the use clause of "any other lease, financing agreement, or master agreement relating to said shopping center..." (emphasis added) was required to be respected by the trustee.

The Bankruptcy Court accepted this argument and held that because of the specific prohibition in the Code against violating a use clause in an "other" agreement, the more general language of Section 365(b)(1)(C), which requires the adequate assurance of future performance under the lease did not relate to the use clause of the lease in question. The judge stated that "this court must be governed by the words chosen by Congress," and that he must therefore "reluctantly rule for the trustee." [1/]

[1/] In re Slacks, Inc., Bankrutpcy No. 482-00273, United States Bankruptcy Court for the District of Montana, Great Falls Division, Order Allowing Assumption of Lease, October 25, 1982, page 4.

The other argument made by the trustee, and accepted by the court, was that any disruption of the tenant mix was not "substantial" because of the small percentage of the area of the shopping center affected by the arcade use.

The Trustee claimed that the disruption was insubstantial because only .1 percent of the area of the shopping center was affected by the arcade use (500 sq. ft./465,000 sq. ft.). This kind of mechanistic analysis does not take into account the local impact of a disruption of the tenant mix on the adjacent tenants. Such an analysis also ignores the importance of the general image of a shopping center to its traffic flow and the fact that the presence of more than one arcade in a medium sized shopping center can substantially change the image of the shopping center.

The court relied on a simple quantitative measure of "substantial disruption," and ignored the more meaningful "qualitative disruption" that the 1978 Amendments to the Bankruptcy Code were intended to prevent. The impact of such a disruption is "substantial" on the nearby tenants and the shopping center as a whole.

Other bankruptcy courts have made the same misreading of the 1978 Amendments.[2/] While this type of analysis may be a minority view, as long as the Bankruptcy Code permits the courts to decide what constitutes a "substantial" disruption, some courts will continue to adopt this oversimplified and erroneous method of judging the degree of disruption.

B. Adverse Impact on Adjacent Tenants Because of Removal of Complementary Business

The tenant space previously occupied by BO-LEGS is directly between two fashionable women's wear stores: Peck & Peck, and Kay's. The manager of the Peck & Peck store and the

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[2/] For example, In re Hughes and Hatcher, Inc., Cas. No. 82B 10152 (JL) Decision, (B.Ct. S.D.N.Y., June 17, 1981) at 30.

owner and operator of the Kay's store testified in the bankruptcy proceeding in support of the shopping center and in opposition to the trustee's proposal to assign the lease to the arcade-pub-sandwich shop.

Both of these stores have been in the Southgate Mall since it originally opened. The owner and operator of Kay's personally negotiated the lease with Southgate Mall. One of her major considerations in deciding to lease in the shopping center was the location of her store. Both she and the manager of Peck & Peck testified that being located in the shopping center next to other high fashion and reputable retail clothing stores benefits their business.

C. Adverse Impact on Adjacent Tenants and on the Shopping Center as a Whole Because of the Nature of an Arcade Business

Video arcades are relative newcomers to shopping centers. Their typical clientele consists of teenagers. This clientele does not provide patronage for the other shopping center tenants to the same extent as would the clientele of a retail clothing store.

Because of the unfortunate correlation between the presence of teenagers and shoplifting, noise, and other disturbances, shopping center owners across the country have treated arcade tenants differently from their other tenants in the following respects:

1. Arcades are located in special areas. They are generally placed near an entrance to the shopping center or near a service corridor to keep their clientele away from the other tenants. The present arcade tenant in the Southgate Mall is next to a service corridor for this reason. Arcades also are located near other areas where a higher than

normal noise level is expected, i.e., food service establishments.

2. Only the very best arcade tenants, with a track record for sound management, cleanliness, and noise and crowd control, are accepted. Aladdin's Castle, the existing arcade tenant in the Southgate Mall, is a nationwide chain and a recognized industry leader in the operation of "good neighbor" arcades.
3. The number of arcades in a shopping center is limited. I am unaware of any other shopping center in the country which has more than one arcade tenant. The Southgate Mall is a shopping center, not an amusement center. There is a concensus within the shopping center industry against having more than one arcade in a shopping center, especially if the shopping center has less than one million square feet of leased space. This view is held without regard to the actual amount of floor space leased to the arcades, because the presence of two arcades has a negative effect on the image of a shopping center even if the amount of leased space is small.
4. Arcade tenants are treated differently than other tenants regarding the amount of their rent and the imposition of special restrictive provisions in their leases. The Aladdin's Castle arcade in the Southgate Mall pays a rent of $13 per square foot. This higher than average rent was set because of the nuisance associated with an arcade and because the clientele of the arcade is expected to cause a reduction in the patronage of the other stores of the shopping center. The Aladdin's lease also contains special lease provisions which require the adequate supervision of the arcade (including

the requirement of the presence of a security guard), impose a prohibition against smoking on the premises, and grant the shopping center the power to terminate the arcade's lease on the grounds that it's operation is "harmful and injurious to the operation, business, reputation or prestige of the shopping center."

5. The frontal area of arcades is limited, and arcade machines must be located so as to keep its clientele within the boundaries of its tenant space.

The placement of an arcade in the BO-LEGS space would violate all of these industry-wide principles of arcade tenancy. The BO-LEGS space is not near an entrance to the shopping center or near a service corridor, and it is not located near other uses where a high noise level is to be expected. The proposed owners and operators of the arcade have little experience in the operation of arcades. The inclusion of their arcade in the mall would result in the presence of two arcades in a medium sized regional shopping center. The BO-LEGS lease contains none of the special restrictions applicable to arcades, although in a supplemental order the bankruptcy court ruled that such restrictions could be included in the lease upon its assignment to the arcade tenant. The frontal area of the BO-LEGS space is not limited.

D. Adverse Impacts on Adjacent Tenants: Possible Bankruptcy

The impact of removing a reputable retail clothing store from the BO-LEGS location and replacing it with an arcade-pub-sandwich shop may be to drive one of the adjacent tenants into bankruptcy. Both of the adjacent tenants testified in the bankruptcy proceeding that the proposed assignment would have a substantial adverse effect on their business. The owner and operator of Kay's testified that the proposed assignment combined with the sales losses caused by the recession and the vacancy of the BO-LEGS space for several months, may force her store into bankruptcy. Not one tenant in the shopping center testified in favor of the proposed assignment, and I am not aware of any tenant who believes that it would help his business.

E. Adverse Impact on the Existing Arcade Tenant

As discussed above, the Aladdin's Castle arcade pays a rent of $13 per square foot. The arcade-pub-sandwich shop which the bankruptcy court would allow to take over the BO-LEGS lease would be paying a rent of only $8 per square foot. Based on discussions with me and based upon the nationwide industry practice, the existing arcade tenant came into the shopping center with the understanding that it would be the only arcade tenant in the mall. Under the proposed assignment, it would not only be competing with a second arcade tenant, but it would be paying rent of 60 percent higher than its competition would be paying. It is expected that the second arcade will reduce the patronage of the existing Aladdin's Castle, thereby reducing its profits and the percentage rent which the shopping center would receive.

Also, the Aladdin's lease prohibits the sale or consumption of food and beverages on its premises, a practice which would be permitted to the proposed new tenant.

F. Adverse Impact on Existing Food Service Establishments

There are presently 17 food service establishments in the shopping center, and they account for 34,681 square feet of shopping center space. Twelve of these, which account for 27,692 square feet of space, would be in direct competition with the 2446 square foot pub-sandwich shop portion of the space of the proposed assignee. The other 5 stores sell ice cream, health food, candies, cookies, etc. Thus, this assignment would increase the amount of leased area in the shopping center devoted to competing food services by 8.8 percent. This clearly represents a "substantial" disruption, even using the quantitative approach taken by the court.

Under the economics of the industry, if the sales of the other food service businesses fall by 8.8 percent, some of them will be in serious economic trouble and may fail. Four of the ten stores in the shopping center in the worst financial shape are food service establishments. The addition of another food service establishment could drive one or more of these establishments into bankruptcy.

G. Adverse Impact on the Other Tenants of the Shopping Center

The debtor currently owes the shopping center $16,515 for back rent and other charges from the months of June-November 1982. The other tenants have also been harmed by this bankruptcy proceeding. The BO-LEGS space has been vacant since July of 1982. Even if the court accepts our settlement offer at the hearing scheduled for February 15, it will not be possible to find a replacement tenant, renovate the space, and open the store again until approximately May. During this 11 month period, the adjacent stores have suffered sales decreases which they could ill afford as a result of the vacant BO-LEGS space.

H. Appeal and Continuing Negotiations

This case is presently on appeal before the 9th Circuit Bankruptcy Panel. However, in order to ensure that this space will be leased to an tenant contributing to the businesses of the other tenants in a reasonable amount of time, and to avoid the costs and uncertainty of result of the appeal, we are continuing to negotiate with the trustee to regain control of the lease.

III. Conclusion

The Shopping Center Protections Improvements Act of 1982, passed by the Senate last year, contained changes in the

Bankruptcy Code which are very much needed by solvent shopping center tenants and shopping centers. The only parties who are clearly benefitted are the bankruptcy lawyers whose services are necessary to litigate the ambiguities in Section 365 of the Code.

The situation in the Southgate Mall demonstrates the divurgence between the interests of the trustee and the interests of the shopping center and the tenants which will remain in the shopping center after the debtor is gone.

It is important that the Congress make effective the protections which it realized in 1978 were necessary for shopping center tenants. The current financial difficulties, widespread throughout the country, are seriously exacerbated by the operation of the Bankruptcy Code.

I urge the Congress to pass this important legislation before additional unjustified and unnecessary harm is done to shopping center tenants and shopping centers.

SOUTHGATE MALL

TENANT MIX EVALUATION - 1982

TENANT	AREA	%
SHOES		
Proposed	24,292	10.0%
Actual	(20,594)	(8.48%)
Gallenkamp Shoes	3,432	
Kinney Shoes	3,360	
Naturalizer Shoes	1,099	
Ogg's Shoes	3,650	
Thom McAn Men's	1,205	
Thom McAn Women's	2,645	
Baker Shoes	2,500	
Footlocker	2,433	
JR. DEPT. STORE		
Proposes	19,433	8%
Actual	(17,538)	(7.22%)
Place Two	17,538	
WOMEN'S R-T-W		
Proposed	48,585	20%
Actual	(48,939)	(20.15%)
Anita Shop	4,937	
The Closet	2,390	
Dahle's Queen&Tall	3,285	
The Daisy	1,065	
Foxmoor Casuals	1,825	
Jean Nicole	4,867	
Kay's Dress Shop	1,460	
Lerner Shop	5,988	
Maurice's	3,650	
Conrad's	2,738	
Peck & Peck	2,240	
Stevenson's	3,650	
Wardrobe	3,381	
Jay Jacobs	3,640	
The Altogether	1,708	
Jenny's Fashions	1,162	

TENANT	AREA	%
SPECIALTY R-T-W		
Proposed	7287	3.0%
Actual	(6268)	(2.58%)
DANA'S	1304	
Shirt Works	976	
Motherhood Maternity	915	
Young Generation	3,479	
MEN'S R-T-W		
Proposed	29,150	12.0%
Actual	(32,100)	(13.21%)
Chess King	2,494	
Dahle's Big&Tall	3,305	
Kaufman's	6,000	
K-G Men's	5,723	
Mr. Mark	1,315	
Squire Shop	3,640	
Bo Legs	2,946	
Desmonds	6,677	
FOOD		
Proposed	29,143	12%
Actual	34,681.1)	(14.78%)
Baskin-Robbins	976	
Brandy's	1,249.5	
Bonaparte's	1,710	
Dairy Queen	372	
G.N.C.	2,218	
Gyros	735	
Hickory Farms	2,279	
Hol'n One	1,464	
J.B. Big Boy	2,691	
King's Table	6,188	
Lenny's Lounge	1,516.6	
Orange Julius	1,147	
Rafferty's Candies	766	
Slice-A-Pizza	1,525	
Pancho's	2,501	
Snickerdoodles	750	
Rocking Horse	6,593	

TENANT	AREA	%
JEWELRY		
Proposed	7,288	3%
Actual	(6,932.70)	(2.85%)
Zales	1,470	
Don Davis Jewelers	1,367	
Edward Jewelers	1,460	
Morgan Jewelers	915.7	
Schubach Jewelers	1,720	
HOUSEHOLD		
Proposed	9,717	4%
Actual	4,250	(1.75%
House of Fabric	4,250	
GIFTS		
Proposed	21,857	9%
Actual	(21,113.1)	(8.69%)
Gift Crate	1,033.4	
Hatch's	5,044	
Higgins Hallmark	4,910	
Magic Muchroom	3,420.7	
Garden City Floral	2,528	
Spencer Gifts	2,677	
Everything Under the Rainbow	1,500	
SEASONAL & MISC.		
Proposed	41,297	17%
Actual	(40,493)	(16.67%)
Bathtique	1,162	
Bell Pipe Shop	465	
Command Performance	1,962	
Merle Norman	366	
Regis Hairstylists	1,022	
State Optical	980	
Universal Athletics	1,487	
Smith Knife & Stone	457	

TENANT	AREA	%
SEASONAL & MISC. continued		
B. Dalton	3,655	
Hi County	2,885	
Clowntown	2,518	
Western Sportsman	6,971	
Coles Books	3,611	
Hobby Shoppe	1,220	
Craft Creations	1,500	
Lowrey Organ Center	1,470	
Musicland	3,356	
Radio Shack	2,064	
Kay Bee Hobby & Toys	3,432	
1 HR. PHOTO LAB	898	
NON-RETAIL		
Proposed	4,857	2%
Actual	(5,153)	(2.2%)
Lambros Realty	812	
Global Travel	405	
Alladin's Castle	2,716	
Phone Center Store	1,220	
VACANT SPACE		
Actual	(4,862)	(2%)
Vacant Space	1,125	
Vacant Space H3	2.433	
Vacant Singer Space	1,304	
TOTAL	242,923.80	

EXHIBIT "B"

DESCRIPTION OF PREMISES

That storeroom in the City of Missoula, County of Missoula, State of Montana, containing approximately 2,946 square feet of Floor Area with a frontage of approximately 20 feet and a depth of approximately 133 (irregular) feet. Said storeroom is located in the Building labelled D on Exhibit "A," with the approximate location of the premises outlined in red thereon.

USE OF PREMISES

Tenant may use the premises only for a retail clothing store engaged primarily in the sale of unisex tops (e.g. coats, jackets, leisure tops, blouses, sweaters, knit tops, cut and sewn shirts, t-shirts, novelty tops and similar items for both male and female) and pants (e.g. cords, slacks, jeans, or any other such clothing for male and female persons), as well as any other items considered to be, in Tenant's opinion, fashionable clothing or fashionable accessories. In addition thereto, the Tenant shall be engaged in the rental of formal wear and sale of shoes, underwear, and other related items. The primary business is not the sale of suits or sports coats, unless the market for the foregoing products becomes depressed or otherwise unprofitable for the Tenant, and therefore, the sale thereof by the Tenant is necessary.

TRADE NAME OF TENANT

Tenant shall operate the premises under the trade name of Bo-Legs

STEIN SIMPSON & ROSEN
LAW OFFICES
1370 AVENUE OF THE AMERICAS
NEW YORK, NEW YORK 10019
212-489-0220

CABLE ADDRESS
STABRAROSE NEW YORK

NEW JERSEY OFFICE
STEIN JOSEPH & ROSEN
222 BRIDGE PLAZA SOUTH
FORT LEE, N.J. 07024
201-859-3678
201-592-1900

February 1, 1983

FEDERAL EXPRESS

Douglas Comer, Esq.
Chief Counsel
Sub-Committee on the
  Courts of the Senate
  Judiciary Committee
2204 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Comer:

In accordance with our recent telephone conversation, I am enclosing herewith two copies of a memorandum which I have prepared setting forth the objections to the substantive changes in Section 365 of the Bankruptcy Code which have been proposed by the shopping center industry. With due respect, I submit that the reasons set forth in the enclosed are more cogently developed, and more grounded in experience, then are the factually unsubstantiated claims of the spokesmen for the shopping center industry.

I am sorry that I did not have the opportunity to appear in person at what you have advised me was the short hearing held on this subject, at which only the shopping center industry was represented, if only to indicate to the members of the Committee that there is in fact an opposing position to be heard.

I trust that the enclosed will nevertheless be incorporated into the record and will be taken into account by those who must make the final decisions on behalf of the public.

Thank you for your consideration in this matter and be assured of my willingness and desire to participate in any further hearings or informal discussions that may be had.

Sincerely yours,

David B. Simpson

DBS:bh
Enclosure

STEIN SIMPSON & ROSEN

MEMORANDUM

TO: The Committee on the Judiciary of the United States Senate

DATE: February 1, 1983

FROM: David B. Simpson

RE: Proposed Amendments to Section 365 of the Bankruptcy Reform Act of 1978 (Title II, United States Code) Concerning the Rights of Bankrupt Tenants

Suggested revisions to Section 365 of the Bankruptcy Reform Act of 1978 (the "Bankruptcy Code") threaten to undo benefits which the Code conferred upon financially-distressed retail businesses having assets which include shopping center leases. Any retail chain or other debtor leasing space in shopping centers which is hereafter compelled to seek protection under the bankruptcy laws will find that its interests will have been severely and adversely affected should the proposed revisions be enacted. Such amendments should be rejected because their effect will be to make it materially more difficult for bankrupt tenants occupying premises in shopping centers either to retain their leases or to sell them to third parties if that is a necessary step in a successful reorganization or plan of arrangement.

In threatening to make the successful reorganization or arrangement of retail chains far more difficult, the proposed amendments are inimical to the interests not only of the bankrupt tenants themselves, but also to those of their creditors, employees and shareholders. The revisions serve the interests of only a single and very narrow class of creditors -- shopping center landlords. They are particularly inappropriate for adoption by Congress at a time of severe, and in some respects, unprecendented economic distress which has resulted in a record number of major retail chain bankruptcies in the last year.

1. INTRODUCTION.

Several years ago, Congress, after extensive study, enacted the Bankruptcy Code (so called in contradistinction to its predecessor statute, the Bankruptcy Act). The Code became effective October 1, 1979.

Among the significant substantive changes effected by the Code were a number of provisions which liberalized and enlarged the rights of insolvent tenants who had sought protection from creditors under the bankruptcy laws. In some respects, the Code merely codified prior case law; in other respects, it enlarged the substantive rights of tenants beyond prior statutory and case law. The Code expressly invalidated provisions in leases which gave landlords the right to terminate leases in event of a tenant's bankruptcy, as well as those which prohibited bankrupt tenants from selling and assigning their leases. The Code also provided new statutory authority for a court to reject strict and literal enforcement of all of the terms and provisions of a lease where such enforcement would effectively destroy the value of the leasehold to the tenant and would frustrate the tenant's ability to reorganize by preventing tenant from realizing on such value either by retaining the leasehold for its operations or by selling it to a third party. The Code's provision governing the rights of bankrupt tenants vis a vis their landlords are substantially emobidied in Section 365 of the Code.

Legislation (Senate Bill S. 2297, 9th Congress, 2nd Sesstion) to amend Section 365 passed the United States Senate in 1982 and is expected to be reintroduced in the current session. That legislation would substantially modify a number of the provisions of the Code which had recognized and enlarged the rights of bankrupt tenants. This legislation is a direct outgrowth of an intensive lobbying effort which has been mounted by the International Council of Shopping Centers (the "ICSC"), a group which is dominated by the country's largest shopping center landlords.

The provisions of the Code governing leases were the product of years of consideration, extensive hearings and much lobbying by interested parties; they reflected a careful effort to accommodate the interests of the various parties and to effect workable compromises where interests were seen to conflict. The shopping center industry was successful in obtaining the incorporation into the Code of a number of provisions, applicable only to leases of stores in shopping centers, which afforded to such leases special treatment different from that accorded to leases generally, intended to confer upon landlords of shopping centers rights not given to lessors generally.

Given the limited period of time during which the Code has been in force, amendment of Section 365 at this time is unwarranted. The Code specifically singled out shopping center landlords for treatment more favorable than that accorded lessors generally, and the industry group sponsoring the instant legislation at the time pronounced itself satisfied with that treatment. No record whatever has been made to establish that, based upon its actual operation, Section 365 was either poorly conceived in principle, or that bankruptcy courts have abused their discretion in construing and enforcing it. Although the proponents of amending Section 365 dwell at length on the characteristics of shopping centers as integrated and interdependent complexes of retail stores, they fail to acknowledge the vast differences that exist among shopping centers, or that such differences render many of the expressed concerns totally inapplicable in many instances. The assumption that any change in use of a store is necessarily adverse to the landlord or to other tenants is not only unsupported by the record but is in fact incorrect.

A handful of cases have been cited to justify the amendments. In fact, an examination of the cases cited fails to prove the necessity for the amendment. The much-mentioned case of Reyco of Nevada v. Johns, 5 BCD 1074 (D Nev. 1979), involving the conversion of a discotheque to a male striptease parlor, in fact involved a finding that the new use was not inconsistent with the prior use and did not constitute a material breach of the lease. The case involved neither a court-sanctioned change in use nor the authority of bankruptcy courts to change use clauses by virtue of Section 365. In the Hughes & Hatcher bankruptcy, the court in two instances authorized mens' wear stores to be used for the sale of ladies' wear where this was necessary to permit the sale of the leases, the objecting landlords having failed to prove, after lengthy hearings, any resulting detriment. (In one instance, the landlord testified as to his willingness to leave the debtor's space vacant for as much as ten years, and there was also testimony that he contemplated putting a ladies' dress shop into adjacent vacant space.)

The record equally fails to provide any factual support for the proposition that shopping centers suffer increased losses because debtors having leases for closed stores are more dilatory than are their landlords in locating replacement tenants (the Hughes & Hatcher proceeding noted above proves that the contrary will often be the case), or that debtors have been successful in postponing for unreasonably protracted periods the determination of applications by landlords seeking assumption or rejection of leases. To the contrary, there is evidence that landlords have attempted to frustrate attempts by bankrupt lessees to assign leases to third parties while at the very same time the landlords themselves have been negotiating directly with such proposed assignees for new leases of the same space upon terms more favorable to the landlords.

It is particularly inappropriate to amend the Code so as to curtail the rights of tenants not only so soon after its enactment, but also at a time of increasing economic distress. It is a hard fact that bankruptcies are everywhere increasing, and that many of these bankruptcies involve companies with potentially significant real estate holdings in the form of leaseholds. In the last year alone, chains such as Sambo's, J. W. Mays, United Department Stores, Lionel, Giant Supermarkets of Scranton, Pennsylvania, KDT Industries (Kings Department Stores) the Wickes Companies and HRT Industries (Hartfield - Zodys), among others, have filed for protection under Chapter 11 of the Code; all of these companies hold many leases among their assets. Indeed, the Wickes bankruptcy, involving a multi-division retailer with some 3,000 locations (most of which are leased) represents the largest retail bankruptcy ever.

The amendments cannot be justified by reference to the acknowledged principle of the sanctity of contracts. The Supreme Court of the United States has recognized that "bankruptcy proceedings constantly modify and affect the property rights established by state law *** The power given Congress by Article I, Section 8, of the Constitution to establish laws relative to bankruptcy gives it broad latitude to affect both contract and property rights." Wright v. Union Central Life Ins. Co., 304 U.S. 502, 517 (1938). Indeed, the modification of the contractual rights of all classes of creditors, including landlords, is central to the whole bankruptcy process. If the objections to the process were to turn on this issue, the entire utility of the process would be lost.

2. THE CRITICAL IMPORTANCE OF PRESERVING THE INTEREST OF BANKRUPTCY TENANTS IN THEIR LEASES.

A number of chain-store bankruptcies in recent years have established that leaseholds can be valuable assets. The right to retain leases relating to a bankrupt's continuing operations may be essential to its prospects for a successful reorganization. The right of a bankrupt to sell leaseholds not required for on-going operations may be equally critical to its ability to finance a settlement with its creditors.

The 1978 bankruptcy of Food Fair, Inc. -- which emerged from its recently concluded proceedings as a scaled-down but profitable regional supermarket chain operating under the name "Pantry Pride" -- played an important role in establishing these facts. Although Food Fair's proceedings were conducted under the more restrictive provisions of the old Bankruptcy Act, and not under the Code, an examination of the results of that bankruptcy reinforces the undesirability of eroding the liberal treatment accorded tenants under the Code so soon after its enactment and in the face of economic conditions which have not only forced increasing numbers of companies into bankruptcy but which also operate to reduce the field of competitors willing and able to purchase even valuable leaseholds which are offered for sale by bankrupt tenants.

In the case of Food Fair, a company was restored to financial health, thousands of jobs were preserved, and creditors were given a very substantial settlement, and the equity of the shareholders were saved. These results were made possible because the sale by Food Fair of its closed-store leaseholds resulted in the realization of several hundred millions of dollars, which was critical to its plan of arrangement. At the same time, Food Fair was able to retain some 100 key leases which it required for its continuing operations because equitable considerations were permitted to temper the operation of the stringent provisions of the old Bankruptcy Act, which might otherwise have frustrated the retention of such properties.

A lessee's business may be destroyed if it is forced, as the result of its bankruptcy, prematurely to surrender leases which are required for continuing operations. A lessee in financial difficulties may find it necessary to realize on the value of its leaseholds by selling those which are no longer required for its continuing business operations. Over the last decade, general inflation and high land and building costs have driven up the value of many old leases. The current recession has not eliminated values which have been built up over a lengthy period of time, although it has contracted, in some instances severely, the number of prospective purchasers for any particular leasehold. KDT Industries, for example, is in the process of selling leaseholds which will result in proceeds running into the tens of millions of dollars, which will be available to fund its plan of arrangement with creditors. Without the ability to realize upon the value of these leases -- which are valuable because they are very old and carry below market rentals --the creditors of KDT would realize but a small fraction of what they will otherwise. No legitimate interest is served by allowing a bankrupt's landlords the benefit of the windfall inherent in recapturing such valuable leases.

There is no inconsistency between acknowledging the legitimate interest which landlords, especially landlords of shopping centers, may have in the identity of the occupants of their premises and at the same time recognizing the equity which tenants may have in the leases of such premises. If the landlord is enabled by the circumstance of the tenant's bankruptcy to recapture the lease and the demised premises, a windfall will be conferred upon the landlord. The landlord's own investment, if any, may have been long since recouped from rentals paid, through depreciation, or through a combinatin of both. Depending upon the particular circumstances, the tenant may have a greater financial investment at stake in the shopping center, and more at risk, than the landlord. At least equally important, the relief which a bankupt tenant may require in order to preserve a leasehold either for continuing operations or for sale may have no adverse impact upon either the tenant's landlord or upon other tenants at the shopping center.

3. THE OPERATION OF THE BANKRUPTCY CODE.

The Code, in its general thrust, conditions the debtor's ability to "assume" and thereby retain, or to sell, the lease upon the condition that the bankrupt provide "adequate assurance of future performance" under the lease. The Code, however, recognized that special problems may exist with respect to leases in shopping centers. In an effort to expand the protection accorded landlords of shopping center leases, the Code provided a definition of what would constitute "adequate assurance of future performance" of a shopping center lease. Thus, it was a precondition of the right of a bankrupt tenant to retain or assign a shopping center lease that such assumption or assignment not, among other things, breach _substantially_ provisions contained in other agreements relating to the shopping center, and that it not disrupt _substantially_ the tenant "mix" or "balance" at the shopping center. The Code nowhere, however, dictates that the right to assume a lease for purposes of either retaining it or selling it necessarily requires that, under all imaginable circumstances, all of the terms and conditions of the lease be strictly complied with, either by the bankrupt lessee or by a third-party assignee.

4. SPECIFIC PROBLEMS POSED BY THE PROPOSED AMENDMENTS.

The amendments which have been previously proposed (and were embodied in Senate Bill S. 2297) would make it far more difficult, and frequently impossible, for a bankrupt tenant either to preserve or to retain a lease for premises in a shopping center.

The Code does not define what a shopping center is; the amendments would have operated equally with respect to all shopping centers leases, without regard for the significant differences that may exist among types of shopping centers, and without consideration of the specific factual circumstances affecting a particular lease. There are many different kinds of retail store complexes which are commonly understood to constitute shopping centers, ranging from "strip" centers consisting of a few stores with a common facade and off-street parking, to multi-story atriums in office towers, to million-square foot enclosed regional shopping centers with hundreds of tenants spread over large areas. It is bad law-making to adopt rigid rules which would rob the bankruptcy courts of their authority to exercise their equitable discretion in the face of these differences and with due regard to the different types of business and financial problems that may be posed for different centers as the result of the bankruptcy of differing types and classes of tenants, occupying different amounts of space, in different relative locations, paying different rents, selling different goods, and generally of differing degrees of importance to the success of the entire center, its landlord and its other tenants.

It is also bad law-making to foreclose bankruptcy courts from granting relief fashioned to take into account such relevant circumstances as the vacancy rate in a center, the landlord's own intentions to rent space for the use from which he seeks to preclude his bankrupt tenant, and the landlord's efforts to negotiate a new lease with the same party to which the landlord has objected in the context of a proposed assignment by his bankrupt tenant. Yet this would be the effect of the proposed amendment.

(a) The Financial Test.

It has been proposed that the Code be amended so that, in order for a shopping center lease to be assumed by the bankrupt so as to permit its assignment to a third party, "adequate assurance of future performance" under the lease will require that the assignee have an "operating and financial performance, including guarantors, similar to that of the original tenant when the lease was executed." The standard would make it impossible for a once-substantial debtor to sell and assign its leases to smaller, albeit successful operators. It would also make it impossible -- regardless of the other terms of the lease itself or of any statutory latitude in modifying use clauses -- to permit an assignment to a user whose business was different than that of the bankrupt, since such a party, by definition, would never satisfy the requirement of having a similar "operating performance." The provision thus functions, independently of any other proposed change, to forestall any changes in the use of a premise. This requirement would effectively prevent any bankrupt tenant which at one time had had a substantial net worth and financial standing from selling its leases, no matter how critical sale of such leases may be to its successful reorganization. It would also, by its requirement for a similar "operating performance", prevent a lease from being assigned to a third party for any use other than that previously maintained by the bankrupt, regardless of the terms of the lease itself.

(b) The Requirement that a Tenant Assume all Provisions of the Lease.

It is proposed that assumption or assignment of the lease be expressly made subject to all of the provisions thereof, including, but not limited to, provisions such as radius, location, use or exclusivity. This amendment would conclusively resolve, in favor of landlords and against tenants, all issues concerning the ability of bankrupt tenants to obtain modification of excessively narrow use provisions or of other provisions which could frustrate the ability of a lessee to retain or to sell a lease. Highly restrictive use provisions, if given literal effect, can effectively frustrate the ability of the debtor to find a third-party purchaser for its lease, particularly in a shrinking economy; such provisions may also prevent the debtor itself from continuing to use the premises if its business undergoes any form of reorganization and results in even an immaterial change in use.

In furtherance of this restrictive objective, the proposed amendment specified that the assignment or assumption of the lease cannot involve or be accompanied by any breach -- no matter how insubstantial -- of any provision contained in any other agreement relating to the shopping center. Thus, if the landlord's mortgage had provided that no change could be made in any lease without the mortgagee's consent, that alone would preclude any expansion of the use clause. The Code, as it presently exists, would preclude such non-compliance from constituting a default by the landlord. The impact of this amendment is not confined to its validation of excessively restrictive use clauses which courts might otherwise refuse to enforce on the grounds that to do so would be inequitable. Such a statutory provision would encourage landlords to incorporate into leases provisions likely to be difficult or incapable of continued performance by a tenant in bankruptcy, or emerging from bankruptcy, or by an assignee of the bankrupt tenant. Such objectionable provisions could include:

> (a) Provisions which restrict the use of the demised premises to a single narrow purpose, so as to severly limit the number or class of prospective assignees.
>
> (b) Provisions containing conditions which are personal in nature, and which would be difficult or impossible for an assignee (or even a lessee emerging from reorganization proceedings) to satisfy, such as provisions decreeing that a change in lessee's management or business will constitute a violation of, and thus a default under, the lease.
>
> (c) Provisions containing financial ratio covenants or conditions which the lessee is required continuously to maintain, such as those relating to maintenance of a specified net worth.
>
> (d) Provisions giving the landlord the right to recapture the leasehold in event of the tenant's cessation of business operations for a particular period of time, or in a particular manner, or under a particular trade name.
>
> (e) Provisions giving the landlord the right to require the payment to it of all or a specified portion of any consideration which the tenant would receive in connection with a proposed assignment or subletting.

Such provisions can operate to negate entirely the benefits which the Code's prohibition against enforcement of bankruptcy clauses and non-assignment clauses has conferred upon tenants. Given literal effect, provisions of the type described will prevent a tenant from either retaining or selling its leases and can thus totally frustrate a tenant's ability to reorganize. This will in turn prevent the tenant's creditors -- other than its landlords -- from obtaining any of the benefits of the possibly substantial equity which the tenant may have in its leaseholds.

(c) The Elimination of the Concept of "Substantiality" in the Enforcement of Restrictive Lease Provisions relating to Use and Tenant Mix.

Consistent with the proposed modification of Section 365(b)(3)(C) so as to specify that assumption or assignment of the lease is subject to all provisions thereof, including provisions which would have the practical effect of preventing assignment, it has been proposed that the flexible provisions of the Code, relating to the enforceability of use and similar restrictions and provisions governing tenant mix, be deleted. The Code provides that radius, location, use or exclusivity provisions in other leases affecting the shopping center are not operative in all circumstances to frustrate a proposed assumption or assignment, but only if assumption or assignment (and the resulting future use of the premises) would breach any such provision "substantially". Likewise, assignment or assumption of the lease (and the resulting future use of the premises) is permitted so long as it does not disrupt "substantially" any tenant "mix or balance" in the shopping center.

The Code should not be amended so as to prohibit assumption or assignment of a lease in every instance where the consequence might be to disrupt the tenant mix or balance in a shopping center. Such an automatic nullification of the right to assign, without any consideration of the materiality of such a disruption or the reality of any alleged adverse consequences to the landlord or to other tenants in the shopping center, will effectively frustrate the basic objectives of the Code to protect the tenant's equity in its leaseholds by enhancing their alienability and marketability.

(d) The Requirement that the Debtor Assume or Reject the Lease Within Sixty Days of the Debtor's Filing For Relief.

It is also proposed that the debtor be compelled to assume or reject a lease within sixty days after the filing of its petition for relief, upon penalty that the lease will otherwise be deemed rejected, unless the debtor, for cause shown, affirmatively obtains within such period an extension of the time within which it may make this election. This is not consistent with the practical exigencies of a bankruptcy case. Examination of the record in any one of the major pending retail bankruptcy cases will clearly establish that managements of debtors filing for Chapter 11 are rarely able at the outset of a case to make informed decisions about the future scope and scale of their reorganized business operation such as would permit early determinations as to the rejection or affirmance of leases.

Assumption of a lease means that all obligations under the lease irrevocably become an administration expense; the debtor cannot thereafter reject the lease and avail itself of the Code's limitation on the landlord's claim for damages. This prospect will impose an enormous burden on the estate should it develop that a lease has no value, or that, although valuable, it cannot, under prevailing market conditions, be sold because a buyer cannot be found within a reasonable time period, or that, because of a scaled-down level of the debtor's future operations, the lease is not (contrary to original expectations) required for the debtor's reorganization. Any of these determinations can only come after the real estate market has been adequately canvassed, a business plan for the bankrupt developed, and the feasibility of its plan of arrangement evaluated.

The most rudimentary understanding of the dynamics of a Chapter 11 proceeding in its initial stages will establish that, at the outset of a case, the debtor is totally consumed by the day-to-day problems of remaining alive. The kind of real estate evaluation, marketing effort and strategic planning ultimately required to determine the need for disposition of an asset and the implementation of any such determination cannot be undertaken within a short a period of time, especially at the outset of a case. The ability to identify those assets which are needed for on-going operations, and those which can or must be disposed of, and the ability to undertake a marketing program, cannot possibly be accomplished within an arbitrary 60-day period following commencement of the case. On the contrary, the future character and scale of the business are matters which normally require months to determine. Frequently, this analysis requires the assistance of outside management consultants which the debtor may wish to employ of its own accord or whose retention may be required by the creditors of the court. In either case, the retention of such personnel, and the entire planning process, cannot be commenced in time sufficient to allow the bankrupt to make reasonably informed decisions about rejecting leases within sixty days following the filing of its petition. To so require is to spell the death knell for many cases that might otherwise end in the debtor's successful rehabilitation. In such major pending cases as that of KDT Industries, filed in August of 1982, or that of the Wickes Companies, filed in the spring of 1982, decisions as to the close-down of divisions are being made only now, many months past the 60-day deadline proposed to be incorporated into the Code.

5. CONCLUSION.

The amendments which have been proposed represent an attempt to avoid flexibility in the administration of a bankrupt's estate, and to deprive the bankruptcy courts of their ability to consider all relevant equitable considerations in evaluating the extent to which any change in permitted use or in other terms of the lease, whether affecting the bankrupt tenant or a prospective assignee, should be permitted. As presently drafted, the Code reflects the codification into the bankruptcy law of a number of recognized principles of law and equity, including the rule of substantial performance, which prevents contracts from being terminated, or damages assessed, for immaterial breaches, and the equitable doctrine of "balancing the equities", which requires an evaluation of relative harm and benefit to tenant and landlord flowing from the enforcement of covenants and restrictions regulating the use of real property.

Adoption of the proposed amendments will drastically curtail the saluatary equitable powers of bankruptcy courts, and will severely impede the ability of bankrupt tenants to reorganize.

A memorandum, dated January 18, 1979, from Winstonn & Strawn, counsel to the ICSC, to the Government Affairs Committee of ICSC, stated that ICSC "was successful in having the Senate give the shopping center industry additional protection by adopting legislative language" which defined "adequate assurance". That language was the language of the Code. The memorandum further states that the ICSC "was able to convince" the House-Senate Conference Committee to amend Section 365(b)(3) to read as it does, i.e. so as to incorporate the concept of "substantiality". Since that time, there has been no factual showing of need on the part of landlords that would justify the drastic modifications to Section 365 which are now being proposed.

STEIN SIMPSON & ROSEN
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NEW YORK, NEW YORK [illegible]

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[illegible]

STEIN [illegible] & ROSEN
[illegible]

February 7, 1983

VIA FEDERAL EXPRESS

Douglas Comer, Esq.
Chief Counsel
Sub-Committee on the
  Courts of the Senate
  Judiciary Committee
2204 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Comer:

In considering the proposed amendments to Section 365 of the Bankruptcy Code, there is an additional material objection that must be confronted; it had been omitted from my previous memorandum of February 1, 1983. That is the impact of the amendments upon a retail chain's ability to obtain financing to be based, directly or indirectly, upon the value of its equity in its leaseholds.

In making it substantially more difficult for retailers to dispose of their leaseholds and thus detracting from their marketability, a negative consequence of the amendments will be to impede retailers, particularly those in financial distress, from obtaining financing from lenders who might otherwise have been prepared to make loans against the value of leaseholds.

The enclosed memorandum, which should be treated as a supplement to the one forwarded to you last week, addresses this issue; I would like this also to be made part of the record for consideration by the members of the Senate Judiciary Committee.

Sincerely yours,

David B. Simpson

DBS/wpg
Enclosures

STEIN SIMPSON & ROSEN

MEMORANDUM

TO: The Judiciary Committee of the United States Senate

DATE: February 7, 1983

FROM: David B. Simpson

RE: Proposed Amendments to Section 365 of the Bankruptcy Reform Act of 1978 (Title 11, United States Code) Concerning the Rights of Bankrupt Tenants

Concerning the contemplated amendments to Section 365 of the Bankruptcy Code, 11 U.S.C. Section 365, there is an additional substantive objection to the efforts to narrow the rights of tenants having leases in shopping centers not discussed in my prior memorandum on the subject, dated February 1, 1983, as follows:

The equity which a tenant has in the form of a valuable leasehold, while not appearing on its balance sheet, can nevertheless prove important and even critical to that tenant's ability to obtain financing. A number of major retail chains frequently make presentations to their bankers, and to the investment community, concerning the "off-balance sheet" equity which they have in their leaseholds. By identifying and quantifying the value of such assets, they demonstrate an enhanced level of credit-worthiness.

In the case of retail chains which are confronting financial difficulties, their ability to demonstrate the existence of such values to the satisfaction of their lenders can mean the difference between success and failure in obtaining financing for working capital or other purposes. In some instances, the availability of such financing may prove sufficient to keep a company out of Chapter 11 entirely; in other cases, it may allow the company to obtaining financing within the framework of a Chapter 11 proceeding. In either case, such financing can be critical to the company's survival.

By drastically curtailing the conditions under which a retail chain, if forced into Chapter 11, would be able to sell its leaseholds and thereby realize upon the values inherent therein, the proposed amendments will seriously curtail the circumstances under which financially-troubled retailers can raise financing from lenders prepared to extend interim loans against the security of a borrower's leaseholds if satisfied as to the marketability and alienability of such assets. The present form of Section 365 allows borrowers a reasonable latitude in disposing of leaseholds and therefore protects lenders who finance against such leaseholds. The proposed amendment will destroy this assurance.

###

In considering any proposed amendments to Section 365, any legislative action should reflect the broader interests of all parties to be prospectively affected by such legislation, including parties which have not organized themselves to speak on the subject. The amendments to the shopping center provisions of the Code are supported by an organized and particularly motivated interest group, the shopping center industry. Those whose interests would be adversely affected thereby -- including both retailers and their creditors --have not similarly coalesced themselves to address this issue. A major inherent problem is the reluctance of retail chains to identify themselves publicly with an issue that, by the very act of being raised, inevitably suggests the spectre of prospective financial difficulties.

In contemplating any revision of Section 365, the practical effects of such revision on the broad spectrum of parties who will be affected should be fully considered. In this instance, there will be a substantially negative impact upon a broad range of parties. The legal and financial implications of this impact on the many affected groups must be fully considered in their totality before enactment of the legislation would be justified.

STATEMENT OF LAURENCE D. CHERKIS

CONCERNING

SHOPPING CENTER TENANT BANKRUPTCY PROTECTIONS IMPROVEMENTS

I am a member of the New York City law firm of Wachtell, Lipton, Rosen & Katz and have been engaged in the practice of real estate and creditors' rights law since 1970. I have negotiated and written numerous shopping center leases, have handled many sales and financing transactions involving shopping centers, and have participated extensively in a substantial number of insolvency cases, including W.T. Grant Company, Hartfield-Zody's, Inc., National Bellas Hess, Inc., United Merchants and Manufacturers, Inc. and Food Fair, Inc. I am the author of the chapter on executory contracts and leases appearing in 4 Collier, Bankruptcy Practice Guide (Matthew Bender 1981). The views expressed herein are my own and do not necessarily reflect the views of my firm.

This memorandum discusses the provisions of the Shopping Center Protections Improvements Act of 1982 (the Bill), which I understand will be reintroduced this year: (1) amending Section 365(a) of the Bankruptcy Code to provide that the obligations of a debtor-tenant under a lease are to be performed on a current basis after the entry of the order for relief under the Bankruptcy Code, (2) amending Section 365(d)(1) to provide for a 60-day period for assumption or rejection of leases in all cases under the Bankruptcy Code, (3) amending Sections 365(b)(3)(A) and 365(d)(2) to provide that the financial and operating performance of a proposed assignee of a shopping center lease be similar to that of the original tenant as of the date the lease was executed and providing for security deposits from such assignees in certain instances, (4) amending Section 365(b)(3) to confirm that the Bankruptcy Court may not authorize the assignment of a lease by a debtor-tenant if the proposed assignee will breach any of the lease terms, including radius, location, use and exclusivity clauses, (5) eliminating the word "substantially" from Sections 365(b)(3)(C) and (D) of the Bankruptcy Code, and (6) amending Section 541(a) to provide in substance that the debtor's estate does not include a lease which has expired by virtue of its own terms.

Current Payment of Use and Occupation Charges; Assumption and Rejection of Leases Within 60-Day Period

The Bill would amend Section 365(a) of the Bankruptcy Code to provide that the obligations of a debtor-tenant under a lease are to be performed on a current basis from and after the date of the order for relief under the Bankruptcy Code, unless the court for cause extends the time for performance for up to 60 days. The Bill would further amend Section 365(d) to provide that in all cases (not just chapter 7 cases) a lease must be assumed or rejected within sixty days after the order for relief, or within such additional time as the court, for cause, within such sixty day period, may establish. If the lease is not assumed or rejected within such sixty day period, it is deemed rejected.

These two amendments are designed to remedy a number of abuses.

First, under current law, a debtor-tenant is obligated to pay use and occupation charges (and not rent) under a real estate lease until the lease is assumed or rejected. The payments are to be based upon the fair value of the benefit conferred upon the estate for the use of the premises. American Anthracite & Bituminous Coal Corp. v. Leonardo Arrivabene, S.A., 280 F.2d 119, 124-126(2nd. Cir. 1960); 120 Wall Associates v. Schilling, 266 F.2d, 548, 550 (2d Cir. 1959), affirming In re North Atlantic and Gulf S.S. Co., 166 F. Supp. 29 (S.D.N.Y. 1958). Thus, the use and occupation payments made by the debtor the landlord may be in an amount less than the rent reserved in the lease. The landlord in these circumstances may be compelled to make up any shortfall required to pay debt service, taxes and operating costs of the property, and is therefore compelled in substance to finance a portion of the debtor's insolvency case until the lease is assumed or rejected. The proposed amendment to Section 365(a) would eliminate this problem.*

If the debtor has vacated the premises prior to the assumption or rejection of the lease, no payments for use and occupation will be required inasmuch as the estate is not receiving any benefit from the premises under current principles of law. See 120 Wall Associates v. Schilling, supra. In the case of a shopping center property, a debtor may vacate the premises, leave the store unoccupied, and not pay any charges therefor until the lease is assumed or rejected. Moreover, the debtor may defer assumption or rejection of the lease until it can effectuate a sale of that lease pursuant to Section 365(f) of the Bankruptcy Code. In most cases, the proceeds of sale will be paid to the debtor and its general creditors and not to the landlord. Of course, in order to assign a lease, the debtor must first assume the lease under Section 365(b) of the Bankruptcy Code and cure all past defaults. However, in the interim period, the debtor has again compelled the landlord to finance the debtor's lease assignment program.

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* Although under present law use and occupation payments are to be made on a current basis (even if in an amount less than the rent reserved in the lease), the payments are not always timely made. This creates an even greater burden on landlords, who may be constrained to apply to the court repeatedly in order to compel payment. In a case filed in the Southern District of New York, In re The Valley Fair Corporation, Case No. 77-B-2978, the debtor was the lessee of three large discount department stores located in New Jersey. The debtor remained in possession of these premises for the months of April through November 1978 without paying use and occupation charges. In addition, the debtor failed to pay the real estate taxes payable under the leases. With respect to one of the three stores, the landlord was also a tenant under an overlease of the property, so that the failure of the debtor to pay use and occupation charges required the landlord to reach into its own pocket to pay the rent under the prime lease. This was particularly egregious inasmuch as the landlord had itself recently emerged from a Chapter 11 proceeding. The use and occupation payments were not made until a settlement in the case was reached in December, 1978.

If the debtor's lease assignment program is successful, and the lease s ultimately assumed and assigned, the debtor and its creditors will have benefited from the landlord's inability to collect use and occupation charges. The landlord, on the other hand, will merely have been restored to its original position. If, however, the lease is not assumed and assigned, and is instead rejected, the landlord will be relegated to a general unsecured claim for damages arising from the rejection of the lease (Bankruptcy Code §365(g)), but will have no claim for post-petition use and occupation charges inasmuch as the premises were not being occuppied by the debtor.* Hence the debtor will have obtained a free ride from the date of the order for relief until the lease is rejected. The proposed amendment to Section 365(a) would provide current compensation to the landlord while the debtor determines whether or not it will be able to assign its lease.

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* Furthermore, the landlord's claim for damages arising out of the lease rejection is limited in amount in accordance with a formula set forth in Section 502(b)(7) of the Bankruptcy Code. The only other type of claim limited in a similar manner is that of an employee under a rejected employment agreement. Bankruptcy Code §502(b)(8). Lessors under equipment leases and non-debtor parties to contracts and mortgagees are not so limited.

The rules governing the payment of use and occupation charges arose through case law developed under the former Bankruptcy Act. See 3A Collier on Bankruptcy, ¶62.14[2] (14th Ed. 1975). Under Section 70b of the Act, clauses in leases providing for termination were enforceable.* Therefore, landlords were able generally to avoid assignments of their leases by debtor-tenants by terminating the leases, so that the question of the debtor's liability for use and occupation payments for a vacant store pending assumption and assignment of the lease was not of significance. Under the Bankruptcy Code, however, bankruptcy default clauses in leases are not enforceable and the leases are assignable. Bankruptcy Code §§365(b), (e) and (f). It is therefore appropriate to reconsider, as the Bill does, the effect of the old rules relating to use and occupation charges in the light of the Bankruptcy Code's policy of fostering lease assignments by debtor-tenants.

The proposed amendment to Section 365(d) provides that the trustee or debtor must assume or reject a lease within sixty days after the order for relief, or within such additional time as the court, for cause, within such sixty day period, may establish. The purpose of this amendment is to provide landlords of chapter 11 debtors with some measure of certainty as to the disposition of their property and to limit the time in which a store may remain vacant while the debtor determines whether to assume (and perhaps assign) or reject the lease. The effect of a vacant store, and especially a vacant anchor store, upon a shopping center and the other tenants therein is obvious. There may be a substantial loss of traffic, an image of decline, and difficulty in recapturing customers who have turned to competing facilities.

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* The courts, in an effort to avoid forfeitures, engrafted a number of doctrines onto Section 70b to preserve the leases where the only material default was the commencement of the bankruptcy proceeding itself. See, e.g. Speare v. Consolidated Assets Corp., 360 F.2d 882 (2d Cir. 1966); Queens Boulevard Wine & Liquor Corp. v. Blum, 503 F.2d 202 (2d Cir. 1974).

The proposed amendment shifts to the debtor the burden of justifying an extension of the sixty day period, rather than compelling landlords to incur the expense, delay and uncertainty of litigation in moving the court under Bankruptcy Code §365(d)(2) for an order compelling the debtor to assume or reject a lease within a period determined by the court. There are several examples of cases under the former Bankruptcy Act in which landlords have elected to waive all or a part of their claims against the debtor in exchange for a lease rejection instead of incurring such expense, delay and uncertainty. Thus in the W.T. Grant Company case (United States District Court for the Southern District of New York, Case No. 75-B-1735), the debtor had embarked upon a program to contract its operations, thereby necessitating the vacation of many of its locations. However, in many instances Grant would surrender possession of store premises but failed to apply to the Court for authority to reject or assume the lease of the premises. In return for a prompt rejection of a lease, Grant offered and received from a number of landlords agreements waiving a part or all of the landlords' post-petition administrative claims and pre-petition claims together with claims arising out of the rejection of the lease.

A purported class action was filed against Grant as debtor-in-possession alleging that the agreements with the landlords had been unlawfully obtained. Berger and Lee v. W.T. Grant Company, Debtor. Although the case was ultimately dismissed, and Grant's actions were found to have been permitted under the Bankruptcy Act, it exemplifies the feeling of many shopping center owners that they should be entitled to an expeditious assumption or rejection of their leases as a matter of law.

Substantially the same practice was followed in a case entitled In re Hartfield-Zody's, Inc., Case No. 74-B-1633, which was also filed under the old Bankruptcy Act in the United States District Court for the Southern District of New York. Harfield-Zody's was a retailer having locations in Michigan and California. During the 1974 recession, the Michigan locations, which were substantially dependent upon the welfare of the automobile industry, became highly unprofitable and Hartfield-Zody's was forced to divest itself of such locations. Hartfield-Zody's accordingly entered into numerous agreements with landlords of the Michigan properties (and indeed certain landlords of its unprofitable California properties), which provided for claim waivers substantialy similar to the waivers described with respect to W.T. Grant Company above.

Similarly, in the matter entitled In re The Walter Reade Organization, Inc., Case No. 77-B-42 (filed under the old Bankruptcy Act in the Southern Distict of New York in January 1977), certain landlords of Walter Reade motion picture theaters likewise executed agreements waiving certain claims in exchange for a prompt rejection of their leases.

The proposed amendment to Section 365(d) may, therefore, reduce the period within which store properties remain vacant, enhance landlords' ability to obtain an expeditious determination as to the disposition of leases in reorganization proceedings and enhance landlords' bargaining power in negotiations relating to the waiver of their claims.

Financial Standing of Assignees; Security Deposits

The Bill also proposes an amendment to Section 365(b)(3)(A) of the Bankruptcy Code providing in substance that an assignee of a lease should have financial and operating performance similar to that of the original tenant under the lease as of the date the lease was executed. Under Section 365(f) of the Code, "adequate assurance of future performance" must be provided in connection with the assignment of a lease. The amendment seeks to limit the discretion granted to the courts under the Bankruptcy Code to determine whether adequate assurance of future performance has been provided by establishing minimum standards for the financial wherewithal of proposed assignees. Similarly, the proposed amendment providing for security deposits in certain cases, likewise adds substance to the concept of adequate assurance of future performance.

Binding Effect of Use Clauses and Other Lease Terms Upon Prospective Assignees

The Bill proposes an amendment to Section 365(b)(3) to provide in effect that the Bankruptcy Court may not authorize assignment of a shopping center lease if the assignee will breach any of the terms of the lease, including terms relating to radius, location, use and exclusivity. This amendment resolves what may be an ambiguity in Section 365(b)(3)(C) as to whether the Bankruptcy Court has the power to change a use clause in a shopping center lease in order to foster an assignment of the lease to a different type of user.

The use clause in a shopping center lease is of major importance to a shopping center landlord and to the other tenants in the shopping center. Annexed to this submission as Exhibit A is the transcript of a seminar held under the aegis of the International Council of Shopping Centers in 1978 relating to "tenant mix" for small shopping centers. The participants in the seminar discuss the considerations involved in blending different types of anchor tenants in a center, the effects of discount stores, supermarkets, fast food operations and motion picture theatres, the proper location of these facilities, and their effects on parking layouts and pedestrian traffic flow. It is readily apparent from the transcript that the tenant mix in a shopping center lease is a matter of sophisticated real estate expertise which may affect the viability of an entire center or of certain tenants therein. It is likewise clear that a change of use of an anchor store in a shopping center may have a materially adverse effect upon the satellite tenants. The proposed amendment to Section 365(b)(3) would confirm that an assignee of a shopping center lease will be bound by the terms of the lease, including any restrictions on use contained therein.*

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* Annexed hereto as Exhibit B is an April 20, 1982 decision of the United States Bankruptcy Court for the Southern District of New York (In The Matter of U.L. Radio Corp., Bankruptcy No. 81 B 11067), authorizing the assignment of a lease by a debtor engaged in electronics sales to a restaurant operator despite a clause in the lease limiting the use of the premises to electronics sales. The case did not involve a shopping center.

Elimination of the "Substantiality" Standard

The Bill also proposes an amendment which will eliminate the word "substantially" from Section 365(b)(3)(C) and (D). Inclusion of the word "substantially" in these provisions permits the courts to authorize lease assignments which to the degree determined by the court may violate an existing radius, location, use or exclusivity clause in another lease or agreement. Elimination from these provisions of the word "substantially" will not, however, diminish the courts' power to interpret such clauses or to authorize the assignment of a lease to a party which will comply with the limitations contained therein. As demonstrated above, compliance with the operational structure created and maintained by a shopping center landlord may be critical to the viability of the center. The proposed amendment merely seeks to confirm that the courts will enforce these arrangements.

Confirmation that an Expired Lease is not Property of the Estate

The Bill also proposes an amendment to Section 541(b) of the Bankruptcy Code to provide in substance that the estate of the debtor does not include a lease which has expired by its terms. This amendment confirms that a trustee may not seek to resurrect a lease which has expired prior to the commencement of the case, and is intended to eliminate an area of litigation which has arisen in respect of leases which apparently had expired before a filing by reason of prepetition defaults. See, for example, In re GSVC Restaurant Corp., CCH Bankr. L. Rep. ¶67,408 (SDNY 1980), and In re Richards Pontiac, 6 B.R. 773 (Bankr. EDNY 1980).

Exhibit A

Shopping Center Report
AN EXCLUSIVE SERVICE FOR MEMBERS OF ICSC

INTERNATIONAL COUNCIL OF SHOPPING CENTERS / 665 FIFTH AVENUE, NEW YORK, N.Y. 10022

Tenant Mix for Small Centers

Developers and retailers discuss tenant mix considerations in small shopping centers

Growing in numbers as well as sophistication, small shopping centers now are facing many of the same kinds of tenant mix questions that have been applicable to regional projects.

Tenant mix for small centers was the subject of a wide-ranging discussion at ICSC's annual convention in May, 1978.

The following is an edited transcript of the panel discussion among developers and retailers active in the small center field.

It covers, among other points, which new tenant types are entering small centers, what developers and retailers think about small center mix, preference in store location and co-tenancies, and what developers can do to improve their mix.

PANELISTS:

Chairman: Richard C. Biagi,
Vice president for real estate, Lucky Stores, Inc., Dublin, Calif., a diversified retail company, which operates more than 1250 supermarkets and other retail stores throughout the U.S. Former vice president and trustee of ICSC.

Richard D. Bronson,
President, R. D. Bronson Companies, Bloomfield, Conn., a shopping center development company which has developed large and small projects from New England to Tennessee. Former ICSC state director.

Albert B. Glickman,
Senior partner, Glickman, Crumpler, Riley & Associates, Beverly Hills, Calif., developers of some 150 shopping centers, principally community and neighborhood projects. Former trustee, ICSC.

Norman B. Krone,
Senior vice president, Physical Resources, Walgreen Co., Chicago, operators of more than 640 Walgreen drugstores and over 300 food service units. Trustee, ICSC.

E. W. (Ed) Spieckerman,
Vice president, real estate, Radio Shack, a division of the Tandy Corporation, Fort Worth, operators of more than 4,000 Radio Shack stores throughout the U.S. and Canada.

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BIAGI: I'd like to ask the developers—from their observations—to tell us what new types of tenants are beginning to show up in small centers. What trends do they see as far as the neighborhood and community type shopping centers are concerned?

■

GLICKMAN: I find that there is a dramatic change. Not more than five years ago the biggest problem in building small centers was overbuilding of satellite stores. From our experience we found that a heavy ratio of satellite space may have looked good on paper and in our pro formas but when completed the space was very difficult, if not impossible, to lease.

However, the pendulum swings, and things do change. Several years ago we said that if you built a market and a drug store, plus some free-standing buildings like banks and savings and loan associations, you shouldn't put in more than 10,000 to 15,000 square feet of satellite stores.

We are now finding that we build 50 per cent to 100 per cent more satellite space and lease it. Several centers that we recently built in the 200,000-square-foot-range have as much as 60,000 square feet of satellite space, including restaurants, financial institutions and free-standing buildings. The same generally applies to smaller centers with supermarkets and drug stores. Secondly, home improvement centers are now playing a big role in small centers. Another big space user is the catalogue store. As for some of the smaller tenants, amusement centers, fast food shops, health spas, weight clinics and now discos are considered viable small-center tenants.

But the most significant thing is the return of the soft goods tenants . . . the fabric, shoe, dress and men's stores. They have been gone from small centers for 10 or 12 years, but they are coming back and they are very successful in our centers. It could well be that the reason for their return to smaller centers is the relative high cost of going into regional centers. It stands to reason that the more traffic you have in the center, the better these tenants will perform.

These tenants are finding that they need to do only 50 per cent to 60 per cent of sales volume as compared with regional centers to make the *same profit* due to lower occupancy costs.

■

BRONSON: In smaller centers, particularly those in New England, we haven't seen any exciting new tenant types . . . mostly convenience stores, discount health and beauty aids, and the like. Chains have become a bigger factor in recent years in small centers. They are aggressively looking for locations. The small convenience food stores also are cropping up quite often.

■

BIAGI: What you said at the end is significant; the cost of mall space per square foot is forcing some of the soft goods tenants back.

■

GLICKMAN: It is more than just pure rental costs. Usually in regional centers, the developer gives tenants a shell and it costs them so much money to put their stores in.

■

BIAGI: In other words, it is the economics of being involved in a regional center that is pushing this trend. I'd like to amplify that just a bit. From my own observations, it looks as though some of these highly specialized tenants—the specialty dress stores and, more recently, shoe stores—are particularly interested in smaller centers that are in the immediate vicinity of a regional center. You will find those types of tenants attracted to the site because of the traffic drawn by the regional. In this way they get the automobile exposure to the storefronts without paying the tariff of mall rents.

How about our two retailer panelists? Do you have anything to add on the new types of retailers that you see in small centers?

■

KRONE: One of the things we are seeing is the growth of specialty grocery stores. By that I mean the store that sells produce only, or meats only; the limited line type of operator. In some cases they may sell high end merchandise; in others they can be described as discounters. One of these is known as Aldi. We had an operation in one of our Globe stores in Houston called Agmar that is a high-end produce operator tied in with a produce wholesaler. In the Chicago area we are seeing a number of the former National and A & P stores taken over by both Aldi and Agmar type operations. In some cases I expect to see them in the same building, but divided up under two different managements.

They have proven to be good traffic builders for us and very desirable co-tenants. We are taking a harder look at locating next to an Aldi-type operator than we would have in the past. Our stores, as an example, have a great deal of general merchandise; these operators do not. Therefore, in the same development with the same amount of traffic, we are able to capture the general merchandise or drugstore type merchandise business that formerly was going in part to the 40,000 square foot supermarket sitting next to us.

The discotheque, on the other hand, I think is a negative merchandiser within the center and we are looking into its effect on us.

■

BIAGI: On discos, you indicated that you are checking them very carefully. I, as a neighborhood retail tenant, would be very much concerned about the kind of traffic they would attract. However, discos are becoming more an accepted type of entertainment and they do not necessarily cater to one type of clientele.

The problem with discos, comes in terms of the hours they operate and the physical arrangement of the center.

■

SPIECKERMAN: I have to agree that discos are probably an undesirable tenant for other retail operations. I say that not just because of the clientele they attract and the empty beer bottles, etc., but because they take up a lot of parking space that could otherwise be used for retail merchants.

One of the most significant trends that was brought out earlier is the return of the specialty store. You cannot even call it a return, because many are locating for the first time in strip centers. They are doing this mostly for economic reasons . . . high rents, high cost of building stores in regional malls. But I think a lot of them are now looking to neighborhood market penetration to a greater degree than they did in the past.

Another very significant development has been the grocery store. Not so many years ago, a grocery store was 18,000 to 20,000 square feet. Essentially it was a food store, although it carried a few cosmetics. Today, you are finding supermarkets in the 40,000 plus square-foot-range with a wide selection of merchandise, hard goods and soft goods. Many of them are becoming departmentalized. They may carry wide selections of delicatessen specialty foods, plants, hardware and so on.

It is really amazing. I think this is good for the center and other tenants. It's a traffic builder. Their appearance has improved. Their design is so much more attractive than it used to be.

■

BIAGI: Actually, if one were to analyze what a small center is, the first characteristic that comes out would be the limited amount of retailing space available. Since specialty-type retailers concentrate a greater depth of a particular line of merchandise in a small space, it makes them a natural for a small center.

I think you will find that those who pick off a segment of retailing and become specialists in it, (i.e. a strata of the shoe business or a segment of the dress business, or the limited-type grocery that we were talking about) are natural tenants for a well-located small center. If some of you have not seen the Aldi stores in the Midwest that we talked about earlier, they are only about 4,000 square feet and they carry something like 850 items of staple grocery products.

Supermarket operators are not necessarily happy about that, but it's a development that is coming along and must be recognized.

■

QUESTION FROM FLOOR: I'm working on a development that is not really downtown, but in an area two or three miles away. I was wondering what the tenants on the panel look for when considering a location close to downtown, that is totally built up residentially, but is going through a tremendous revitalization.

■

KRONE: We are looking, as are most drug chains, for exactly that kind of location. For example, within the city of Chicago, we hope to develop about 25 in-city stores in the next three years.

They represent to us an identifiable market that suburban areas do not have. The density and concentration allow us to have more stores. We are permitted to develop our units in smaller centers. Neighborhood associations or local councilmen will see to it that municipal parking is provided or paid for so that parking is not included in common area maintenance. This saving enables us to be more effective in keeping up the security of the store.

There are real economic benefits and the trade-off obviously is the higher rent paid for the land cost. But we are excited about in-city locations and I think everybody in our industry is.

■

SPIECKERMAN: I have to second what has been said. We believe in city locations and we're now developing a downtown project of our own in Fort Worth, Texas. We are not developers, but it will include our home office, a couple of other office buildings, a hotel and ice skating rink, and about 200,000 square feet of retail space.

I am encouraged by what is going on in the inner areas of many of our large cities. I would like to see U.S. cities have the same vigor that we see north of the border in Canada, like in Montreal and Toronto.

■

BRONSON: I am pleased to hear the tenants speaking that way. Today, developers are faced with a rather unique situation. One, almost all tenants are looking for new locations. They are looking for more stores and are very expansion minded. Money is readily available. Notwithstanding the fact that rates are moving up, money is still there for the right project for the right developers.

So you have got tenants looking for locations and money available for the developer. But the problem today is getting what we call the right to build. The problems range from conservation, preservation, curb cuts, air quality, and the like.

We are finding a lot less resistance when we go to develop in-city locations. We find the towns and the local citizens encouraging, not going out of their way to try to organize the bird-and-bunny groups that often come out of the woodwork to stop major centers.

As a developer, I am very pleased to hear the tenants speak so favorably about in-city locations. Such locations are becoming more and more of a factor in terms of our new projects.

■

QUESTION FROM FLOOR: This is directed to Mr. Glickman. How do you lease 60,000 square feet of satellite stores when your major anchor has restrictions in its lease which prohibits discos, cocktail lounges, movie theaters, amusement centers, convenience markets and a whole list of others?

■

GLICKMAN: In the first place, when I spoke of as much as 60,000 feet, I was referring to a center that is usually around 200,000 to 240,000 square feet total, a 20 to 25 acre center.

But when a store like Lucky Stores says, for example, that it doesn't want a theater in the parking lot, they usually don't mind if it is far away from them. Sometimes you can even negotiate that the theater be located 400 or 500 feet away.

As to the whole question of exclusives, with the threat of the FTC and other factors, most tenants are now limiting their restrictions. In fact, we are finding fewer and fewer requests for exclusives and restrictions.

Everything is negotiable and certainly a theater must be considered part of the tenant mix, no matter where it is located on the site. When you lay out your shopping center the theater can be put in the corner of the parking lot. First you must figure the theater's parking needs, then place the structures where there is sufficient parking to support it and still not interfere with store needs.

■

BIAGI: The concern most supermarkets have is the tremendous turnover of parking spaces involved in supermarket shopping. The same situation probably applies for super drug stores.

In the case of supermarkets, we are dealing with a large percentage of women shoppers, who require a large band of available, convenient, close-up parking. In California and much of the West, women shoppers don't use the package pick-up service nearly as much as they do in the Midwest and the East. And, believe it or not, shoppers actually wheel shopping carts with their own groceries out to their car faster than most pick-up arrangements. In addition, wage scales are such that we cannot afford to have convenience or courtesy people around to provide the service. As a result, usurping close-in parking is harmful to the supermarket operator. This not only applies to movie theaters, but to health spas, gymnasiums, beauty parlors, various types of schools and so forth. As a result, the developer must recognize the term of the parking that is characteristic of particular types of tenants and place them where they can operate without killing off the retail side of your shopping center.

■

QUESTION FROM FLOOR: I would like to ask the entire panel to respond to a question on the destiny of major discount stores in a neighborhood center. Are they a good draw for other tenants?

■

SPIECKERMAN: Absolutely. I think a major discount operator is the greatest asset that a neighborhood or community type of center can have. In our operation, for example, we just love to be in a center with K mart or Target; stores that are good, solid discount operators that advertise heavily and draw a lot of traffic.

■

KRONE: We are now finding it to be advantageous. However, for a long time, we felt it was a problem because of the overlapping lines of merchandise. One thing we found is that the layout of the center is critical to the success of the convenience stores if there is a large discounter in the center. If the discounter is put up front, and the grocery and drug are placed deep in the site, it will be harmful for most convenience merchants. This holds true even if the discounter is successful. The discounter will draw the people even if they are deep in the site, thus enabling you to give the prominent positions near the road to the grocer and the drugstore. There also is the problem of stability of parking.

A typical drugstore has some 1,700 people visit it daily. We have to turn the parking spaces near the store frequently. As a result, the long-term shoppers who go to a large department store or discount store have to be segregated on the site.

■

GLICKMAN: We're doing 14 projects now and 11 of them have discount stores in what I call small centers. That sums up our view on discounters.

■

BRONSON: We're bullish on discount stores, particularly in New England. We find that the so-called anchorless shopping centers just don't come off too well. They may work very nicely in the Sun Belt states and in places that are densely populated. But in New England, we find that most tenants basically live off the major draw, and without a major you have problems. As a result, we are anxious to have discount department stores in our centers when we can get them.

■

QUESTION FROM FLOOR: I have more of a comment to make than a question. What's happened in recent years is that the start-up of new regional centers is a very minimal situation. There is a pretty good lead time. It is a lengthy process that really restricts the opportunity for a mall tenant, particularly in fashion soft goods, to move ahead at the rate that it would like to.

Secondly, with the energy crisis, a lot of attention is being directed to closer-in residential units. Many blue collar type areas which were overlooked in the rush to the suburbs are undergoing revitalization.

Thirdly, there is the advent of so many new types of tenants, and some discounters have become quite good. Thus, many enlightened developers are seeking a balanced mix once again in small centers. A lot of developers have recognized the fact that if you have a discounter on one end and a food store on the other end, or a discounter and a relatively weak general department store, you can develop a more unified appeal for the center by developing a fashion mix within the mall itself.

By getting 30 to 50 stores, a lot of developers today are beginning to find that, with proper balancing and upgrading the mix, the center can draw from a wider area and a broader range of customers than if it was primarily discount and service. A lot of good fashion retailers are beginning to take a hard look at these markets, not only because they are cheaper, but because they really afford an opportunity to do a productive job at a fairly high profit ratio. A regional center represents high cost, and it can be very high yield. Smaller centers are relatively low cost, but they can also produce very high yield.

■

QUESTION FROM FLOOR: Do you think a catalogue-type showroom operation dealing only in hard goods can be a suitable substitute for a discount operation as an anchor tenant, provided that you also had a grocery store and a drugstore? They usually occupy about 60,000 square feet, a portion of which is used for warehousing goods.

■

BRONSON: I just made a deal with such an outfit. We find that they are a viable alternative to a typical discounter. They will draw almost as much traffic and they are a suitable operator. In another arrangement in Massachusetts we have this type of tenant in the same center with a major discounter, which is somewhat of a unique departure from the earlier position that they had taken. Because of the scarcity of good new locations, many of the major tenants are softening their stance on who they will and will not go with as co-anchors.

■

GLICKMAN: We find them very desirable. Catalogue operators usually require that you have a heavy soft goods tenant in the center as co-anchor. A discount store will fill the bill. They are terrific traffic generators and do very well in our centers. As developers of small centers we really court them.

■

SPIECKERMAN: From a tenant point of view, I second that. They are excellent anchor tenants. They don't necessarily have to be substitutes for a discounter, but they could be an addition to one.

I would like to comment on one thing that Norm Krone said earlier about the discounter and its placement within the shopping center. I disagree on putting the discounter off to one part of the center, preferably in the back, and putting the grocery and drugstore and the satellite tenants up front. I think the very advantage the discounter offers is the possibility of creating foot traffic. In small centers ordinarily you do not have much foot traffic and by putting the discounter off to one corner of the shopping center you defeat that very purpose. I like to see discounters smack in the middle, provided of course there is enough parking for everybody.

■

QUESTION FROM FLOOR: In reference to movie theaters, I would like to know what kind of contribution they make to the mix of tenants. After all, they operate at night when the center is closed. They have no crowds during the day and cannot afford the rent that a retail tenant can pay.

We have twin movie theaters in a mini-mall. We know for a fact that people arrive there at seven o'clock. They line up at the window to buy tickets and, by the time they leave the mall is closed. We can get at least three times the rent from an office building than from a movie theater if we would convert it.

Why then are developers interested in putting movie theaters in their centers?

■

BRONSON: I would like to comment on this question, if I may. It is a significant question. The major tenants, like supermarkets, discount and drug stores, are really concerned about parking. We do put theaters in our centers, but they are far enough away. Theaters do push a tough rent deal, but we usually put them in the least desirable part of the parking lot. As to malls, theaters usually just have a little frontage on the mall . . . a little entrance, with most in the back.

The important point is we want to generate traffic. If we have some excess land that doesn't hurt anybody and we cannot do anything else with it, I think theaters are a tremendous generator of traffic. They have a great draw. People will drive as many as 5 and 10 miles to a theater where they usually will not drive more than two miles to a supermarket. If we are generating more traffic and more action in our shopping center and not hurting the parking, I think theaters are a terrific generator and I think it falls in the tenant mix.

■

QUESTION FROM FLOOR: I would appreciate some comments from the panel, particularly from Mr. Glickman as a shopping center developer and owner, as to the placement of small tenants within a strip center. We are developing strip centers of 150,000 to 200,000 square feet with 50,000 to 60,000 square feet of small tenants. We have been placing our soft goods merchants on one end of it and the hard lines on another end. We are starting to get complaints from the hard line merchants that they are not getting the traffic that the soft lines are pulling. I would appreciate your comments on that. I have a second question directed particularly to Mr. Spieckerman. Given the preference or opportunity of going into a strip center or a mall, both in the same general location, which would be better for your company and why?

■

BIAGI: Why don't we take that second question first, Ed.

■

SPIECKERMAN: I don't think you're comparing apples and apples. You do not necessarily locate in one to the exclusion of the other. We try to get into all good regional malls in the country and in Canada that we can. But the regional mall draws from a much wider area than the strip shopping center. Quite often, we have had stores in established strip centers and a year or two later a regional mall is being developed across the street or within a very short distance. We have located in the mall as well. But we did not close our strip center store.

A lot of people may feel that the mall is going to kill that little store, but that's just not so. The little store showed healthy sales increases and the mall store, of course, got off to a quick start and did a big volume right from the beginning. But it takes a lot more volume to support a mall store than it does to support a strip center store.

The great majority of our customers are men. The guy who wants to buy an antenna on Saturday afternoon, or some parts and pieces, is in his old overalls or shorts and doesn't want to go into a mall. He would much rather drive right up to the store, pick up what he needs and go on about his business.

So really, we are talking about two different things. There is a great need for strip center locations and the vast majority of our stores, about 87 or 88 per cent, are in strip centers, neighborhood centers or free-standers. Only about 12 per cent are in regional malls.

■

BIAGI: Al Glickman, will you respond to the layout question?

■

GLICKMAN: Your question raises a very significant problem. Sometimes the site dictates the solution. But if you are going to have 40,000 to 60,000 square feet of satellite space, you must give those people the prime location.

Now, a supermarket, drugstore or discount store will take between 150 and 200 feet of depth and on your plot plan it would be ideal to put them all in one bank and then put all those small stores over to the side wherever they fit. I've done this and it is pure suicide. All you do is keep changing those small tenants. If you are going to merchandise that much satellite space, you must give them what I call 100 per cent location and you'd better put your anchors on the end. This encourages foot traffic and helps the smaller satellite tenants to survive.

Taking all big, deep stores and lining them all up in a row is bad. You must give the smaller tenants the 100 per cent location. They are a developer's bread and butter. They pay the highest rents. If there is a constant turnover because they are going out of business, this creates real problems for the success of a center.

■

BIAGI: Well, in essence, what we are looking at is a compromise of forces, the physical constraints, the shape of your property, the press of your major tenants to want to be at certain locations, and the need to have your satellites situated in between those major tenants so that you can maximize the exposure and foot traffic.

■

QUESTION FROM FLOOR: There has been an increasing number of national specialty chains showing an interest in strip centers or mini-malls. Some developers feel the national specialty chains have the name recognition, the merchandising power, and the advertising power, and they must be attracted for a successful strip center or mini-mall. How do you feel about strong locals as opposed to national chain specialty stores?

■

BRONSON: I think it is very important to have local operators, and they are just as important as the rated tenants. Many times, lenders jam tenant mix down our throats. In many instances they have a pre-lease requirement specifying the number of rated tenants to have in a particular center. And even though you may feel that a particular local tenant would be a good draw for your center, you are not able to make the deal with them up front because the lender is demanding Triple A rated tenants. So, to a degree, the lender dictates the tenant mix in a shopping center.

Local operators are obviously a big plus. You have to have a good mix of not just fashion and convenience stores, but also a good mix of national tenants as well as local operators.

■

QUESTION FROM FLOOR: A few years ago we saw a sprinkling of some enclosed sidewalk type centers. Most agree that a grocery store and probably a drugstore don't belong in an enclosed sidewalk. But since we are reaching for more soft goods type tenants, I wonder what the reaction would be to enclosing the sidewalk for a portion of the center as a way to improve the tenant mix, with the thought of drawing some more soft goods type tenants into the center.

■

BIAGI: I can start off with a reaction to that. The enclosed sidewalk or climate-controlled sidewalk is directly related to the climatic conditions that are involved. In a number of areas it could be just a waste of money. In certain areas it is a real must. I can see it in the Northeast and I can see it in some of the very hot humid areas. Usually enclosed sidewalks feed into the front corner of the superdrug at, say, one end and the supermarket at the other end, so that they really form both extremes of the enclosed sidewalk. Your other specialty tenants are sprinkled in between. It is an ideal shopping environment, but you must weigh the need for it against the economics involved in actually constructing and maintaining the center. More than ever, utilities and power costs are an extremely important factor. So it takes very careful consideration.

■

KRONE: From a purely economic standpoint, I would say you can do it if you want. But we are not going to tie into it and we are not dependent on it. Therefore, make sure those people who front on it pay all the costs . . . maintenance, heating and cooling.

In the locations where we are tied into enclosed sidewalks, I don't think they have contributed to our sales and I am not yet convinced they contribute to the sales of the small tenants. We have one center that we actually developed, but no longer own, that had an enclosed sidewalk. The current owner got rid of the enclosure and was able to save $15,000 of his own money in maintenance, heating and cooling—costs he would not have been able to pass to the entire strip.

■

SPIECKERMAN: I agree. If a tenant does not want to tie into an enclosed sidewalk and if he does not want to share in the cost of running it, well, what good is it? I was quite excited a few years back when they started building a few in Houston. They were nice looking centers, very well done, but the tenants inside the enclosed sidewalk got very little traffic. Everybody did exactly what they do in an open sidewalk center . . . they pulled up in front of the grocery store and in front of the drugstore. They'd get their shopping done and get back into their cars and drive off. The smaller tenants on the inside did not do well at all.

Another great disadvantage is that of identification. One thing I look for in a neighborhood location is good sign exposure. That is very important to us. Our sign is internationally known and we advertise heavily. We would like to have our sign as big as possible—out there for everybody to see. If you are inside an enclosed sidewalk shopping center, your signing possibilities are severely limited. For that reason I urge developers even in the humid climates to spend their money somewhere else; you would probably get a much better return.

■

BIAGI: What it really boils down to is you have got to be very careful. It is a great idea when you have tremendous foot traffic, and you see that in the larger malls. The tendency of people shopping for convenience products is to go to a particular major tenant, get their merchandise and then leave.

■

QUESTION FROM FLOOR: My question is directed towards the desirability of fast food or take-out food tenants. Are they desirable in terms of others retailers? If so, to what percentage of the mix? Lastly, should they be banked together or distributed throughout the center?

■

BRONSON: Lately we have noticed that McDonalds is taking some in-line locations. Friendly Ice Cream was a forerunner of in-line locations. Of course, the developer looks at the pad location with a somewhat slanted view. Economically, it is a tremendous rent payer and a plus for the center. It may even be possible for a developer with a few pad locations to secure enough rent from those locations to pay for the entire piece of property that he is developing.

Fast food places are terrific traffic generators. They are excellent tenants. If you can get them to go in-line I think you are helping the other merchants in the center as much as you are helping your own development. Typically, the fast food tenants are credit' or rated tenants. This can be a big plus insofar as the lender's desire to have as much rated income as possible in the center.

■

SPIECKERMAN: From a retailer point of view I wholeheartedly agree. If you can get the likes of McDonalds to locate in-line by all means do it. The only problem is parking. They do take up a lot of parking spaces and if you don't have adequate parking, then you hurt your fast food tenant and the other merchants.

■

KRONE: Our position is that they are very desirable. My experience with McDonalds, Burger King and others now going into the strips is that even when they are in-line they are not really taking interior locations. They are really taking an anchor position at one end nearest the highway location. It closely approximates pad-type positioning. By so doing they also solve a parking problem because you have end space which would otherwise be unusable for the other tenants. They generate traffic, give tremendous exposure to the rest of us in the center. If you have a quality operator, we are in favor of it.

■

GLICKMAN: Since we are now building more satellite space in small centers, I would say up to 20 to

25 per cent could be devoted to food. Not all of it should be the McDonalds-type operations. I would say that on 60,000 square feet of satellite space, at least 15,000 square feet of the in-line space could be made up of chicken places, ethnic food—small operators who are traffic generators and are anxious to get into the shopping center.

■

BIAGI: I'm going to ask one final question of both the retailers and developers on the panel. As far as the retailers are concerned, what have developers been doing wrong in small convenience type neighborhood centers?

■

SPIECKERMAN: I think that the basic problem has been a lack of professionalism in the past. I am greatly encouraged to see that more professionals are getting into strip center development than ever before. Some of the major mall developers now have strip center divisions and are applying the lessons they have learned in building malls to the strip center business. I think this is excellent.

But what went wrong in the past is that many people thought that they could just go out and develop a shopping center. Many of them had money, bought a piece of property somewhere, built a shopping center without any regard to the neighborhood, or of the desirability or the need for the center. These projects became nothing more than useless eyesores. The tenant mix quite often is bad because the only thing they looked for was rent dollars. They don't have the first idea of what tenant mix is. They would just as soon put in a dentist or real estate office as a retail tenant.

The other thing is the appearance of the center, its construction. Many of them were cheaply constructed and show it. There is no sign uniformity and no sign restrictions resulting in a hodge-podge of cheap signs. The parking area quite often is insufficient. It is not well maintained. The lighting is inadequate. Ingress and egress are bad. These are problems directly attributable to the lack of knowledge on the part of the person or the individuals who developed the center and a money lender who did not know much more than the guy he loaned the money to.

■

KRONE: I think lack of professionalism is probably the key thing. Site planning in many small centers is deplorable and I would strongly suggest that the major tenants be heard. The long-term investment in small centers is made by two, three or four principal tenants and the developer should listen to their advice. They are interested not only in trying to help themselves, but the entire center. Over the 15, 20, or 25 years that they intend to rent, they want to ensure the viability, success and continued profitability of every tenant in the center. In this way, it is not going to be solely a selfish interest, but rather for the good of all tenants trying to operate in that particular development. The problem is that many developers will not take the advice of the major tenant.

■

BIAGI: I think it is a point well made. Speaking as a retailer, the fact is that retailers do not have a monopoly on brains; it is just that we've done it so many times that we have had a chance to make more mistakes than anybody else. Experience is nothing more than the opportunity of having made a lot of mistakes and hopefully learning by them. Developers could benefit from our experience and mistakes.

■

QUESTION FROM FLOOR: I would like a comment on the feasibility of a merchants association in a small strip center.

■

BIAGI: A merchants association for a small center makes little sense to me. It is just too formal, too powerful for the base over which it is going to be spread, and you are going to hear this from every major retailer. They spend thousands of dollars a week promoting their chain and your center along with it. You don't have a big enough budget in a center of 15 or more acres to support a professional, highly trained promotional director. As a result, promotion will be the stepchild of some store manager or developer who will take care of it in his spare time. The whole thing is completely out of whack economically and practically speaking.

It is a great idea in a larger center where you have the money base, the number of tenants and the size of contribution to do a job. In my view, the question of promotion in a small center should be relegated to a couple of seasonal things throughout the year. You simply do not have the economic base to support someone to do the job properly.

■

SPIECKERMAN: You are 100 per cent right. I do not join merchants associations in the small centers because they are like the United Nations . . . you have all the little nations that do not have any money who do all the talking and then vote on how to spend your money. I just don't believe in that.

■

RINTED IN U.S.A 289/78—6M 50 per copy

Exhibit B

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In the Matter of U.L. RADIO CORP., Debtor.	Bankruptcy No. 81 B 11067 MEMORANDUM & ORDER

FILED
APR [illegible] 1982
JUDGE J. GALGAY
BANKRUPTCY JUDGE

APPEARANCES:

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JOHN J. GALGAY - Bankruptcy Judge

Debtor, U.L. Radio Corp., has moved for an order, pursuant to Bankruptcy Code section 365(f), authorizing it to assume its lease ("Lease") with Jemrock Realty Company ("Jemrock"), the landlord, and authorizing U.L. Radio to assign the Lease to Just Heaven Restaurant, Ltd. ("Just Heaven"). U.L. Radio operates the leasehold as a television sales and service store. Just Heaven, the prospective assignee, will operate the premises as a small bistro. Jemrock opposes such an assignment, citing a use clause in the Lease which provides that the lessee shall use the premises only for television service and sale of electrical appliances. Jemrock asserts that the assignment of the Lease to Just Heaven would unlawfully modify the Lease by violating the use clause. Such modification, Jemrock avers, is not permitted under section 365 without the landlord's consent, which consent Jemrock withholds.

After a hearing, the Court ordered the parties to submit proposed findings of fact and conclusions of law [hereinafter "Findings and Conclusions"]. The Court has considered all the papers submitted by the parties, the oral arguments and the applicable law and legislative history. The Court grants debtor's motion to assume and assign the Lease to Just Heaven.

I. Background

On September 17, 1979, the debtor entered into the Lease with Jemrock for a store located at 2656 Broadway, New York, New York. The store is located in a building which is also occupied by a grocery store, a Chinese restaurant, a liquor store, and 170 apartments. The term of the Lease is for ten years. The rent required to be paid is as follows: $9600 per year from November 1, 1979, to October 31, 1982; $10,800 from November 1, 1982, to October 31, 1985; and $12000 from November 1, 1985 to October 31, 1989. Paragraph 43 of the Rider to the Lease provides that the tenant may assign the Lease with the written consent of the Landlord, which consent is not to be unreasonably withheld.

On May 20, 1981, the debtor filed an original petition under Chapter 11 of the Bankruptcy Code and continues to operate its business as debtor in possession. No creditors' committee has been formed. The debtor intends to propose a liquidation plan of reorganization. The debtor is current in the payment of rent and related charges required by the terms of the Lease and is not in default of any of the Lease terms.

In furtherance of its intention to liquidate all of its assets and to propose a plan of reorganization, the debtor, subject to the approval of this Court, entered into an assignment of the Lease to Just Heaven. The proposed assignment provides, *inter alia*, that Just Heaven will pay to the Debtor as consideration for the assignment as follows: for the period commencing three months after this Court's approval of the assignment to October 31, 1988, the sum of $2000 per month. Such payments will fund a plan paying unsecured creditors 100 percent of their claims. Rockwell International, the largest creditor, recommends the assignment.

The president of Just Heaven has executed a personal guarantee for the payment of rent in favor of the landlord for the first two years of the assignment, together with a statement that her net worth exceeds $50,000.

The Lease provides in paragraph 45 of the rider to the Lease that "any noise emanating from said premises shall be deemed a breach of the terms and conditions of this Lease." Just Heaven has allocated $20,000 for construction, including soundproofing. David Humpal St. James, Vice President and Secretary as well as a director and a shareholder of Just Heaven, is a noted interior designer including the design of commercial restaurants. His design work has involved soundproofing. See Affidavit of David Humpal St. James.

II. Issues

Two issues confront this Court:

> (1) Have the provisions of section 365, regarding assumption and assignment of leases, been satisfied?
>
> (2) Can deviation from a use clause prevent the assignment of a lease, when the assumption and assignment otherwise comport with the requirements of section 365?

III. Assumption and Assignment Under Section 365

Code section 365 governs the assumption and assignment of executory contracts, providing broad authority to a trustee or debtor in possession[1] to assume and assign an unexpired lease. 11 U.S.C. §365(a); see Report of the Committee on the Judiciary, Bankruptcy Law Revision, H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 347 (1977) [hereinafter "House Report"]; Report of the Committee on the Judiciary, Bankruptcy Reform, S. Rep. No. 95-989, 95th Cong., 2d Sess. 58 (1978) [hereinafter "Senate Report"]; In re Lafayette Radio Electronics Corp., 9 BR 993,997 (BC EDNY 1981); 2 Collier on Bankruptcy ¶365.01 (15th ed. 1981). The aim of this statutory authority to as-

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EDITOR'S NOTE.--Footnotes not submitted.

sume a lease is to "assist in the debtor's rehabilitation or liquidation." House Report at 348; Senate Report at 59.

Assignment of a lease,which is at issue here, must comply with section 365(f), which states:

> (f)(1) Except as provided in subsection (c) of this section, notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection.
>
> (2) The trustee may assign an executory contract or unexpired lease of the debtor only if --
>
> (A) the trustee assumes such contact or lease in accordance with the provisions of this section; and
>
> (B) adequate assurance of future performance by the assignee of such contract or lease is provided, whether or not there has been a default in such contract or lease.
>
> (3) Notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law that terminates or modifies, or permits a party other than the debtor to terminate or modify, such contract or lease or a right or obligation under such contract or lease on account of an assignment of such contract or lease, such contract, lease right, or obligation may not be terminated or modified under such provision because of the assumption or assignment of such contract or lease by the trustee.

Subsection (f)(1) "partially invalidates restrictions on assignment of contracts or leases by the trustee to a third party." House Report at 349; Senate Report at 59; see Fogel, Executory Contracts and Unexpired Leases in the Bankruptcy Code 64 Minn. L. Rev. 341,360 (1980) [hereinafter "Executory Contracts"]. Subsection (f)(2) "imposes two restrictions on assignment by the trustee: (1) he must first assume the contract or lease, subject to all the restrictions found in the section; and (2) adequate assurance of future performance must be provided to the other contracting party." House Report at 349; Senate Report at 59.[2] Finally, subsection (f)(3) "invalidates contractual provisions that permit termination or modification in the event of an assignment, as contrary to the policy of this subsection." House Report at 349; Senate Report at 59.

A. Requirements of Assumption

The first requirement of assignment under section 365(f)(2) is proper assumption under section 365. 11 U.S.C. §365(f)(2)(A). The broad authority of a trustee or debtor in possession to assume is limited in Code section 365 by subsections (b), (c), and (d). *House Report* at 347; *Senate Report* at 58.

Section 365(b)(1) and (2) prescribe conditions to assumption of a lease if a default has occurred. "Subsection (b) requires the [debtor] to cure any default in the...lease and to provide adequate assurance of future performance ...before he may assume." *House Report* at 347; *Senate Report* at 58; 2 *Collier on Bankruptcy* ¶365.04 (15th ed. 1981). No default exists under the Lease before this Court; therefore, the subsection (b) requirements for assignment are not applicable.

Section 365(c) prohibits a debtor from assuming a lease if applicable nonbankruptcy law "independent of any language in the contract or Lease itself" excuses the other party from giving performance to or receiving performance from someone other than the debtor. *House Report* at 348; *Senate Report* at 59. Such "nondelegable"[3] and, therefore, non-assumable contracts and leases include those for unique personal services, as well as those to extend credit, to make loans, and to issue securities. The Lease before this Court does not fall under the prohibition of section 365(c). *See* *In re Taylor Manufacturing, Inc.*, 6 B.R.370 (N.D. Ga. 1980).

Section 365(d) sets time limits on the assumption of unexpired leases. The time requirements of subsection (d) have been met and are not at issue.

B. Adequate Assurance of Future Performance

The second requirement of assignment under section 365(f)(2) is adequate assurance of future performance ("adequate assurance"). 11 U.S.C. §365(f)(2)(B). Adequate assurance also appears in section 365(b) as a requirement of assumption if an executory contract is in default. 11 U.S.C. §365(b)(1)(C). The phrase "adequate assurance of future performance" is not found in the Bankruptcy Act.

Adequate assurance is not defined in section 365(f) nor in the legislative history of section 365(f), but "[t]he definition should generally be the same as in section 365(b)." Fogel, Executory Contracts at 362. In the legislative history of section 365(b), Congress while discussing assumption under section 365(b) and the bankruptcy clause under section 365(f), provided this explanation of adequate assurance:

> If a trustee is to assume a contract or lease, the courts will have to insure that the trustee's performance under the contract or lease gives the other contracting party the full benefit of the bargain."

House Report at 348; Senate Report at 59.

Beyond equating adequate assurance with the full benefit of the bargain, Congress offers no definition of adequate assurance except in the case of real property leases in shopping centers.[4] The Lease at issue here is not located in a shopping center. Congress described a shopping center as "often a carefully planned enterprise, and though it consists of numerous individual tenants, the center is planned as a single unit, often subject to a master lease or financing agreement." House Report at 348. The building in which U.L. Radio is located is primarily a residential apartment building, with a liquor store, a grocery store, a restaurant, and U.L. Radio on the first floor. Thus the specific provisions of adequate assurance in the shopping center case do not apply to the assignment at issue here. See In re Lafayette Radio Electronics, 9 B.R. at 998.

Apart from shopping center leases, Congress "entrusted the courts with the definition of adequate assurance of the performance of contracts and other leases." Fogel, Executory Contracts at 359. Adequate assurance of future performance are not words of art, but are to be given practicial, pragmatic construction. What constitutes "adequate assurance" is to be determined by factual conditions. In re Sapolin Paints, Inc. 5 B.R. 412,420-21 (BC EDNY 1980); In re Lafayette Radio Electronics, 9 B.R. at 998. The broad authorization of the trustee or debtor to assume or assign unexpired leases, notwithstanding anti-assignment or bankruptcy clauses, prompted the admonition from Congress that the courts must "be sensitive to the rights of the nondebtor party to... unexpired leases." House Report at 348; Senate Report at 59.

The phrase "adequate assurance of future performance" was adopted from Uniform Commercial Code section 2-609. Report of the Commission on Bankruptcy Laws of the United States, H.R. Doc. No. 93-137, 93d Cong., 1st Sess. Pt II 156-57 (1973). U.C.C. section 2-609 provides that a party with reasonable grounds for insecurity regarding another party's performance may demand "adequate assurance."[5] Official Comment 4 to section 2-609 discusses, inter alia, Corn Products Refining Co. v. Fasola, 94 N.J.L. 181, 109 A.505 (1920), and James B. Berry's Sons Co. of Illinois v. Monark Gasoline & Oil Co., Inc., 32 F.2d 74 (8th Cir. 1929), and indicates that "adequate assurance" focuses on the financial condition of a contracting party and his ability to meet his financial obligations. Regarding adequate assurance under an assignment pursuant to section 365(f)(2), the Court in In re Lafayette Radio Electronics stated, "[T]he Court's primary focus will be on the ability of [the assignee] to comply with the financial obligations under the agreement." 9 B.R. at 998.[6]

In In re Pin Oaks Apartments, 6 BCD 1396 (B.C. S.D.Tex. 1980), the Court found that changes in financial provisions of a lease, a percentage rental clause and a sublease provision which protected that rental clause, precluded a finding that adequate assurance had been provided because of the drastic effect the changes would have on rentals received.

Thus, the primary focus of adequate assurance is the assignee's ability to satisfy financial obligations under the lease. In this case, the president of the assignee has executed a personal guarantee of the payment of rent in favor of the landlord for the first two years of the assignment, together with a statement that her net worth exceeds $50,000. The assignee has budgeted $20,000 for construction, enhancing the chances of success of the assignee's enterprise. The assignee will have operating capital of an additional $30,000. Affidavit of David Humpal St. James at p.3. Upon these facts, the Court rules that adequate assurance of future financial performance has been provided by the assignee.

IV. Use Clause

However, adequate assurance of future financial performance is not the complete statutory requirement; adequate assurance of future performance is. The financial capability of an assignee may be sufficient for a finding of adequate assurance under an executory sales contract or a similar commercial transaction. In a landlord-tenant relationship, more than an assignee's ability to comply with the financial provisions of a lease may be required. More particularly, will compliance with a use clause be required in order to provide adequate assurance?

Congress indicates that adequate assurance will give the landlord the full benefit of his bargain. House Report at 348; Senate Report at 59. In its case-by-case determination of those factors, beyond financial assurance, which constitute the landlord's bargain, the Court will generally consider the provisions of the lease to be assigned. See In re Lafayette Radio Electronics, 9 BR at 998 (a "landlord cannot be granted any greater rights than what the lease provides"); In re Pin Oaks Apartments, 6 BCD at 1400 (citing Hurley v. Atcheson, Topeka & Santa Fe Ry., 213 U.S. 126 (1909), for the proposition that assumption and assignment of a lease entails acceptance by the assignee of the burdens as well as the benefits of the lease).

However, it is equally clear that, by requiring provision of adequate assurance under section 365, i.e.,"the lessor's receipt of the 'full benefit of his bargain'," Congress did not require the Court to assure "literal fulfillment by the lessee of each and every term of the bargain." Simpson, Leases and the Bankruptcy Code: The Protean Concept of Adequate Assurance of Future Performance at 35 (unpublished draft in Bankruptcy Court, S.D.N.Y.) [hereinafter "Leases"].

Section 365, by its own terms, empowers the court to render unenforceable bankruptcy clauses and anti-assignment clauses which permit modification or termination of a lease for filing in bankruptcy or assignment of the lease. 11 U.S.C. §365(e),(f)(3). Section 365(k) relieves the estate of liability for future breaches of a lease after assignment, notwithstanding lease provisions to the contrary. 11 U.S.C. §365(k); see Simpson, Leases at 39.

The Court in In re Pin Oaks Apartments argued that court authority to abrogate lease provisions extends only to those provisions expressly stated by Congress:

> If Congress intended to give this Court or the trustee the power to abrogate any contractual rights between a debtor and non-debtor contracting party other than anti-assignment and "ipso facto" [i.e. bankruptcy] clauses, it would have expressly done so.

6 BCD at 1398.

Such a narrow view of court authority is not supported by the statute or the legislative history. First, such a narrow view would frustrate the express policy of Congress favoring assignment. Under the Pin Oaks reasoning, lessors could employ very specific use clauses to prevent assignment and thus circumvent the Code. Section 365(f), in broad language, empowers the Court to authorize assignment of an unexpired lease and invalidate any lease provision which would terminate or modify the lease because of the assignment of that lease. 11 U.S.C. §365(f)(1),(3). Any lease provision, not merely one entitled "anti-assignment clause", would be subject to the court's scrutiny regarding its anti-assignment effect. The court could render unenforceable any provision whose sole effect is to restrict assignment, "as contrary to the policy of [subsection (f)(3)]." House Report at 349; Senate Report at 59.

Further, when Congress intended that all terms and provisions of an agreement remain unaltered, it expressly stated such an intent. Section 1124 sets down stringent requirements to define unimpaired claims, requiring the cure of defaults and the unaltered maintenance of legal, equitable,and contractual rights. 11 U.S.C. §1124(2)(D). As one commentator points out, these expressed, stringent requirements for unimpaired claims differ from the requirement that Congress mandated under section 365- - mere provision of adequate assurance. Simpson, Leases at 40-1. Under both sections 1124 and 365, Congress expressly stated the requirements. Under section 365, literal compliance with all lease terms was not required. Even under the tightly drawn definition of adequate assurance in the shopping center case, Congress did not envision literal compliance with all lease provisions; insubstantial disruptions in, inter alia, tenant mix and insubstantial breaches in other leases or agreements were contemplated and allowed. 11 U.S.C. §365(b)(3)(C),(D); Simpson, Leases at 28; In re Russell Johns, 1 CBC 2d 174 (B.C. D.Nev. 1979) (insubstantial change in use of leasehold located in shopping center, from adult discotheque to male striptease showcase, permitted).

Thus, provision of adequate assurance of future performance does not require an assignee's literal compliance with each and every term of the lease. The court may permit deviations from strict enforcement of any provision including a use clause. See Simpson, Leases at 41.

One commentator suggested that the court render completely invalid any use clause in a non-shopping center lease because: (1) "the lessor is seeking to protect his tenant mix with the lease provision, and the Code does not require the court to provide such protection"; and (2) a use clause "invalidly conditions assignment." Fogel, Executory Contracts at 364 (footnote omitted); see Simpson, Leases at at 37 n.45. The Court rejects this "per se unenforceable" reading of a use clause.

However, the Court will not go to the other extreme and adopt the "insubstantial" breach or disruption standard for non-shopping center cases that is applicable only to shopping center leases. The insubstantial breaches and disruptions language of section 365(b)(3) "clearly reflects an attempt to limit the effects of what was understood-- and feared-- to be the more expansive authority conferred by the balance of [s]ection 365(a)." Simpson, *Leases* at 37-38 (referring to Krasnowiecki & Vass, *Shopping Centers and the New Bankruptcy Code*, 36 Bus. Law. 79,92 (Nov. 1980); *see* Fogel, *Executory Contracts* at 359). The Court's authority to waive strict enforcement of lease provisions in the non-shopping center cases will permit deviations which would exceed those permitted in the shopping center cases. *See* Simpson, *Leases* at 39.

Within the range between unenforceability of a use clause and insubstantial breaches of a use clause, the Code provides no specific standard by which to measure permissible deviations in use. Whatever standard is applied must serve the policy aims of Congress.

Section 365 expresses a clear Congressional policy favoring assumption and assignment. Such a policy will insure that potential valuable assets will not be lost by a debtor who is reorganizing his affairs or liquidating assets for distribution to creditors. This policy parallels case law which disfavors forfeiture. *See In re Huntington Limited*, 654 F.2d 578,584 n.7 (9th Cir. 1981); 2 *Collier on Bankruptcy* ¶365.06 n.1 (15th ed. 1981). To prevent an assignment of an unexpired lease by demanding strict enforcement of a use clause, and thereby contradict clear Congressional policy, a landlord or lessor must show that actual and substantial detriment would be incurred by him if the deviation in use was permitted.

In this case, the contemplated deviation in use is from an appliance store to a small bistro. The building in which the unexpired leasehold is located already contains a restaurant, a laundry, and a liquor store. The landlord has failed to demonstrate any actual and substantial detriment which he would incur if the proposed deviation in use is permitted. The Court also notes that the contemplated use, along with the planned soundproofing, will have no adverse effect on other tenants in the building. Thus, this Court rules that the use clause may not be enforced so as to block assignment of this lease to Just Heaven. The fact that Jemrock withholds its consent to the proposed assignment will not prevent the assignment. Consent is required only in leases governed by section 365(c). The lease here is not subject to section 365(c). See In re Taylor Manufacturing, Inc., 6 BR 370,372 (B.C. N.D. Ga. 1980).

Finally, the Court briefly addresses the constitutional issue raised by the deviation in the contractual terms of the lease. Can a landlord assert a violation of the Fifth Amendment which prohibits the taking of property without due process of law? The Court in In re Sapolin Paints, Inc., 5 B.R. 412 (BC EDNY 1980), denied the enforceability of a bankruptcy clause, stating:

> 'Bankruptcy proceedings constantly modify and affect property rights established by state law.' Wright v. Union Central Life Ins. Co., 304 U.S. 502,517...(1938). The power given Congress by Article I, Section 8, of the Constitution to establish uniform laws relative to bankruptcy gives it broad latitude to effect both contract and property rights. Wright v. Union Central Life Ins. Co., supra; Kriehner v. Irving Trust Co., 299 U.S. 445...(1937); Continental Illinois National Bank & Trust Co. v. Chicago-Rhode Island R.R. Co., 294 U.S. 648...(1935).

Id. at 423; see In re Huntington Limited, 654 F.2d 578, 590 9th Cir. 1981) (Circuit Court permitted assumption and assignment of a lease and permitted assignee to further hypothecate the lease in contravention of lease provision).

Congress, in section 365, has stated a general policy favoring assignment. Balanced against this general policy is the requirement that the non-debtor contracting party receive the full benefit of his bargain. Jemrock Realty will receive the full benefit of its bargain under the proposed assignment of the leasehold from U.L. Radio to

Just Heaven. No defaults exist under the lease. The lease has properly been assumed and Just Heaven has provided adequate assurance of future performance. The landlord has shown no actual or substantial detriment to him from the proposed assignment. The statutory requirements have been satisfied. The assignment is authorized.

It is so ordered.

Dated: New York, New York
April 19th 1982

John J. Galgay
Bankruptcy Judge

STATEMENT OF

WALLACE R. WOODBURY

ON

SHOPPING CENTER TENANT BANKRUPTCY PROTECTIONS IMPROVEMENTS

FEBRUARY 3, 1983

My name is Wallace R. Woodbury. I am an attorney and Chairman of the Board of Woodbury Corporation. The Woodbury Corporation is a 60 year old real estate development, brokerage, and management firm headquartered in Salt Lake City, Utah. It has been intermittently involved in the development and management of regional, community, and neighborhood shopping centers as well as free-standing commercial, industrial, and office buildings. I am also a member of the Government Affairs Committee of the International Council of Shopping Centers (ICSC).

Last year, I testified before the Courts Subcommittee on behalf of my firm and the ICSC in support of the Shopping Center Protections Improvements Act of 1982, S. 2297. In my testimony last year, I described the legislation and explained the need for it.

The purpose of my statement this year is to reaffirm that testimony. The problems which I discussed last year have not been resolved, and, because of the worsened state of the economy, have grown more serious. In considering this legislation, I would like the committee to bear in mind some examples of the real problems which exist under the Bankruptcy Code, and which this legislation would alleviate.

The John Price family trust, the owner of a Las Vegas shopping center known as Regency Plaza, reports that a tenant known as Beatto's Restaurant filed a Chapter 11 bankruptcy petition in June 1981. The landlord's attorney immediately commenced efforts to collect the rent due or to recover possession of the premises. Notwithstanding these efforts, Beatto's continued to operate until December 1981, but never paid any rent or other charges due under the lease during this time. After the space was vacated, the landlord was unable to recover possession and control of the premises until October 1982. This space was vacant for 11 months, and no rent or other charges were paid for 16 months. In addition, the landlord incurred extensive legal expenses in recovering possession of the premises.

Hermes Associates, which operates two shopping centers in Las Vegas, Nevada, leased space in one of its shopping centers to a California-based tenant known as "Brandalls." Brandalls filed for bankruptcy under Chapter 11 on March 16, 1981. Rents were paid through 1980. The trustee reported to the court that the leasehold interest was of no value to the estate and recommended to the court that Brandalls surrender the lease to the landlord after the bankrupt moved from the premises. Despite the trustee's recommendation, the California court refused to take any action. In order to obtain permission to pursue an action to recover the premises the landlord was required to pay

$2,000 to the bankrupt estate. After such payment, possession was surrendered to the landlord in July, and the landlord was unable to locate new tenants until October. The landlord received no rental for the period from January through September.

In another case, in Ogden, Utah we had leased a space to Odyssey Records and Tapes, a California headquartered company, and the adjacent space was occupied by a complimentary tenant, Stokes Brothers, a TV, electronics, and computer business. Odyssey exercised a renewal option, and, almost immediately thereafter, filed a bankruptcy petition and vacated the premises. The lease limited the use of the property to the retail sale of records and tapes, and forbade any assignment without the consent of the landlord. The trustee refused to pay rent or other charges or release the premises to the landlord despite the fact that the landlord had available to rent the property a substitute replacement tenant with substantial assets who complied with the use restriction in the lease. Over the landlord's objection, the trustee in the California court sold and assigned the lease to a shell corporation named Rocky Mountain Sales which sold substantially the same types of merchandise as the neighbor tenant, Stokes Brothers, and which advertised "going out of business prices" as a sales promotion. The landlord objected without avail to the changed use of the space, the inadequate capital of the new tenant, and the use of prohibited promotional advertising methods by the new tenant. After 6 months of ruinous competition, the adjacent tenant, Stokes Brothers, abandoned the premises on the grounds that the landlord had given them an exclusive in their lease for the sale of their type of merchandise and that this lease clause had been violated. After 13 months, the trustee's tenant, Rocky Mountain, abandoned the premises, and left substantial amounts of delinquent rent and physical damage to the premises. However, the landlord was without remedy because Rocky Mountain was impecunious.

Thus, as the result of the operation of the Bankruptcy Code, the shopping center ended up with vacancies in two stores, the substantial loss of rental income, and considerable building damage and the nonbankrupt tenant ended up losing a substantial sum of money and was forced to abandon the shopping center because of the trustee's utter disregard of the lease provisions which were bargained for and designed to protect both the landlord and the non-bankrupt adjacent tenant.

In another Utah shopping center case in 1981, relating to a building at 3600 South and 600 West Salt Lake Valley, Morris E. Anderson tried to prosecute default proceedings against its tenant Alpha Corporation which had filed Chapter 11. The law requires a plan to be submitted within 120 days. However, no plan was submitted after more than 240 days. Despite this, the court was unwilling to release the property to the landlord, until a plan was filed, resulting in a rental loss of more than $35,000. In addition, although the lease granted the landlord a lien on the tenant's furnishings and equipment, the Court conducted an auction to sell the tenant's equipment and did not give the landlord permission to prosecute any action to protect its interest.

Another recent bankruptcy case involves a nine thousand square foot Hughes and Hatcher store in the Severn Mall Shopping Center in Cleveland. The tenant is headquartered in New York and the lease expires January 31, 1983. The tenant closed its doors and moved out of the Cleveland Shopping Center on February 1, 1982. Subsequently the tenant filed Chapter 11 proceedings in upstate New York. Despite the fact that by May of 1982 the trustee and the attorneys for the bankrupt both stated that such a short remaining leasehold had no value and should be surrendered to the landlord, the New York court refused to make any decision to accept or reject the lease because no formal reorganization plan had yet been filed.

These types of problems continue to plague the shopping center industry because of the failure of the 97th Congress to enact legislation to cure the defects of the current Bankruptcy Code. I strongly urge Congress to pass the Shopping Center Tenant Bankruptcy Protections Improvements as soon as possible in order to avoid the imposition of the unnecessary and unjustified hardships on shopping centers and the retailers located in shopping centers caused by defects in the current Bankruptcy Code.

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